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TAXATION OF COMMERCIAL AND PRIVATE ANNUITIES UNDER THE INTERNAL REVENUE CODE OF 1954

Harold G. Wren

ECONOMIC ASPECTS OF INVENTIONS & LEGAL MONOPOLIES

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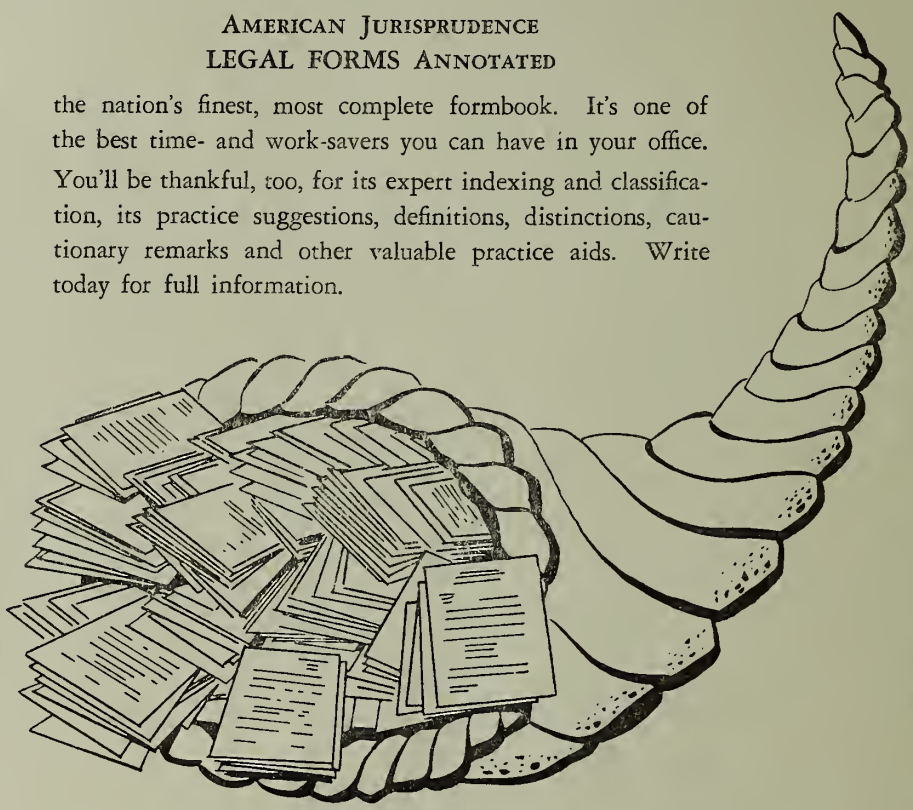

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TAXATION OF COMMERCIAL AND PRIVATE ANNUITIES UNDER THE INTERNAL REVENUE CODE OF 1954

*Harold G. Wren**

I. Introduction

The Internal Revenue Code of 1954 has brought a number of changes with respect to the taxation of annuities. On the whole, these changes are for the benefit of the taxpayer, and there is now a greater opportunity than ever before to use such contracts in estate planning for the protection of the breadwinner and his family, upon retirement and at death, with a minimum of harsh tax consequences.

The taxation of annuities has always been one of the most difficult problems in the administration of the tax laws.[1] The difficulty stems from the peculiar nature of the annuity, viz. the fact that the amount to be received under the contract is not definitely ascertained until the

*Professor of Law, University of Oklahoma.

[1]The magnitude of this problem can be appreciated when it is remembered that Americans put nearly $1.2 billion into the purchase of annuities in 1953. There are now 4.5 million annuities in force with U. S. life insurance companies providing for annual income payments of nearly $1.7 billion. Of this total income $605 million is provided under individual annuity contracts, $934 million represents income from group annuities, and $133 million is to be paid under supplementary agreements set up with life insurance proceeds. The growth of annuities from 1935 to 1953 can be seen in the following table:

ANNUITIES IN FORCE IN U. S. LIFE INSURANCE COMPANIES
(000 omitted)

	Individual Annuities			Group Annuities		Supplementary Annuities
Year	*No.*	*Am't. Annual Income*	*Certificates*	*Am't. Annual Income*	*No.*	*Am't. Annual Income*
1935	710	$375,000	230	$ 65,000	30	$ 15,000
1940	940	475,000	640	135,000	75	30,000
1945	1080	528,000	1213	273,000	130	58,000
1950	1235	585,000	2210	593,000	217	102,000
1953	1277	605,000	2986	934,000	273	133,000

Type of annuities in force in 1953 with U. S. life insurance companies were as follows (000 omitted):

	Individual Annuities			Group Annuities	Supplementary Annuities	
	No.	*Am't. Annual Income*	*Cert.*	*Am't. Annual Income*	*No.*	*Am't. Annual Income*
Income now Payable	454	$157,000	211	$119,000	208	$ 58,000
Income Deferred but fully paid	173	72,000	2652	764,000	65	35,000
Income Deferred but not fully paid	650	376,000	123	51,000		

Life Insurance Fact Book (1954), Institute of Life Insurance, New York.

death of the annuitant. Three categories for annuities have been recognized in the tax laws:

1. the ordinary commercial annuity, i.e. the typical annuity contract which can be purchased from a life insurance company;

2. the private annuity, i.e. the arrangement where a person or institution promises to pay the annuitant a certain sum for his life in exchange for property which the annuitant transfers to the promisor; and

3. the employee's annuity, i.e. the annuity paid to an employee during his retirement, or to his beneficiary, at his death, under a retirement plan to which both the employer and the employee normally contribute.

We shall consider how commercial and private annuities are affected by the income, estate, and gift tax provisions of the Internal Revenue Code of 1954. No attempt will be made to treat of the problem of employees' annuities which are subject to special provisions in the new Code.[2]

II. Commercial Annuities

A. *Income Taxation*

Section 72 of the 1954 Code completely changes the method of taxing the ordinary commercial annuity under the income tax.[3] It lays down a general rule to the effect that the amount to be excluded shall be apportioned over the life expectancy of the annuitant. In the words of the statute:

> Gross income does not include any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).[4]

Within this general rule are three new statutory concepts: (1) the "investment in the contract," (2) the "annuity starting date," and (3) the "expected return under the contract." The new method of taxing annuities is given prospective operation only, by means of the definition

[2] Int. Rev. Code (1954) §§ 72 (d), 401-404, 501 (a).

[3] The section does not apply where an annuity is used to discharge alimony obligations to the extent that the annuity payments are includible in the gross income of the wife under § 71 or § 682. Int. Rev. Code (1954) § 72 (k). Moreover, the section does not apply to life insurance proceeds payable by reason of the death of the insured. Such proceeds, although often payable to the beneficiary in the form of an annuity, are wholly excludible from gross income, except for the "interest elements" (measured by the difference between the aggregate value of the payments expected and the discounted value of such payments). Even this "interest element" is excluded, up to $1,000 per year, if the beneficiary is the widow of the insured. Int. Rev. Code (1954) § 101 (a).

[4] Int. Rev. Code (1954) § 72 (b).

of the annuity starting date. This is the "first day of the first period for which an amount is received as an annuity under the contract," except that if the contract was made before 1954, then the annuity starting date is January 1, 1954, the effective date of the new law.[5]

The investment in the contract is the cost of the annuity minus any amounts excluded from gross income prior to the annuity starting date.[6] The expected return under the contract is the amount of the annual payment due under the contract multiplied by the decedent's life expectancy,[7] or by the number of installments, if the contract provides for payment over a fixed period of years.[8]

1. *Life Annuities*

Under the three per cent rule of the old Code, the taxpayer excluded from his gross income that portion of each annuity payment which exceeded three per cent of his cost, until he recovered his cost by way of tax-free recovery. Thereafter, the entire amount of the annuity was taxable as income.[9]

This rule had very harsh results, to say the least. First of all, the three per cent was entirely arbitrary; the amount includible in gross income became very heavy after the annuitant had recovered his cost, at the time he needed the most protection; and the annuitant had to live well beyond his life expectancy before he would have any possibility of recovering his cost.[10]

The new rule is as helpful to the taxpayer as the old rule was

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[5] INT. REV. CODE (1954) § 72 (c) (4).

[6] INT. REV. CODE (1954) § 72 (c) (1).

[7] The Commissioner has issued temporary rules governing the taxation of annuities under the new Code. The rules include actuarial tables for measuring the expected return on ordinary, joint life and last survivor, and refund annuities, for males and females. T. D. 6118 published in Federal Register, Dec. 31, 1954.

[8] INT. REV. CODE (1954) § 72 (c) (3).

[9] INT. REV. CODE (1939) § 22 (b) (2).

Prior to 1934, receipt of payments under an annuity contract was taxed only if the annuitant had recovered his cost. 38 Stat. 167 (1913) (exclusion of proceeds from gross income). 39 Stat. 758, Sec. 4 (1916); 40 Stat. 329, § 4 (1917); 40 Stat. 1065, § 213 (b) (2) (1919). 42 Stat. 238, § 213 (b) (2) (1921); 43 Stat. 268, § 213 (b) (2) (1924) (amounts received "as a return of premium" excluded from gross income). 44 Stat. 24, § 213 (b) (2) (1926); 45 Stat. 797-778, § 22 (b) (2) (1928); 47 Stat. 178, § 22 (b) (2) (1932) ("amounts received . . . under an . . . annuity contract," are excluded, "but if such amounts (when added to amounts received before the taxable year under such contract) exceed the aggregate premiums or consideration paid . . . then the excess shall be included in gross income.") The three per cent rule was enacted in 1934 and subsequently incorporated into the Code. 48 Stat. 687, Sec. 22 (b) (2) (1934); INT. REV. CODE (1939) Sec. 22 (b) (2). The House Report explained the new law as follows: "Statistics show that an increasing amount of capital is going into the purchase of annuities, with the result that income taxes are postponed indefinitely. The change merely places the return of this form of investment on the same basis as other forms of investment by taxing that portion of each payment which in fact consitutes income." H. Rep. 704, 73rd Cong., 2d sess. (1934), p. 21.

[10] In Egvedt v. U. S., 112 Ct. Cl. 80 (1948), a case involving an immediate annuity, the taxpayer showed that he would have to live to be 100 before he could get his cost back tax-free.

harsh. A comparison of the methods of taxing a particular annuity will show the advantages of an annuity under the new Code.

Assume that the taxpayer has a life expectancy of 10 years and that he can purchase an annuity for $10,900, which will pay him $1200 a year for the rest of his life. Under the old law, the taxpayer would be required to report $327 (3% of $10,900) as taxable income until he recovered his cost in tax-free recovery. Any payments received thereafter would be taxable in full. Thus, during the first twelve years of the contract, $873 would be excluded from gross income. In the thirteenth year, $776 would be includible, while $424 would be tax-free. In the fourteenth and subsequent years, the entire $1200 would be taxable income.

Under the new Code, the amount of annual tax-free recovery is determined by dividing the cost of the annuity ($10,900) by the annuitant's life expectancy (10 years), or $1,090 a year.[11] This amount is excluded from gross income. The balance ($110) would be includible in gross income. The most important thing about the new law is that *this method of taxation continues whether or not the taxpayer lives beyond his life expectancy.*[12] A comparison of the total amount of income that is includible under the 1939 and 1954 Codes, depending upon whether the taxpayer lives for five or fifteen years, reveals the following:

If annuity lasts:	There is includible under the:	
	Old Rule	New Rule
5 yrs.	$1,635	$ 550
15 yrs.	$7,100	$1,650

2. *Refund Annuities*

Many commercial annuities provide a refund feature. By this type of contract, if the annuitant should die before reaching his life expectancy, his beneficiary is entitled to recover the difference between the total payments already received and the consideration paid. Such payments may be paid to the beneficiary in a lump sum or in installments.

Under the old Code, if paid in a lump sum, no income tax would be imposed on the beneficiary until there was a recovery of the cost of

[11]Actually, the statute prescribes a ratio for determining the amount of the exclusions, *supra*, note 3. If x equals this amount, then the ratio would be: x: $1,200 = $10,900: 10 x $1,200. It will be observed that the $1,200 figure will cancel out, making it possible to determine the exclusion by dividing the cost by the annuitant's life expectancy.

[12]That some consideration has been given to the problems of life insurance salesmen is indicated by the Report of the House Ways and Means Committee: "Under this rule the company providing the annuity will be able to supply the annuitant with a statement indicating that for the rest of his life a stated amount of his annuity income will be excluded annually from his income subject to tax." 83rd Cong., 2d sess. House Rep. No. 1337 (1954), p. 19.

the annuity by the annuitant. If, however, the payments were made in installments, under an old ruling,[13] the amount of each payment includible in the gross income of the beneficiary was determined by dividing the number of payments to be made, into the difference between the aggregate of the payments to be made and their commuted value.

This rule was subsequently modified[14] so as to provide that there would be no income realized until there had been a return of capital, i.e., when the total of the amount of tax-free recovery which the annuitant had received plus the aggregate of payments to the beneficiary, exceeded the cost of the annuity. The new Code provides that a refund, whether paid in a lump sum or installments, will be taxable only to the extent that such a payment exceeds the consideration paid for the contract.[15] In order to avoid a double exclusion, the 1954 Code contains a new provision which requires that the investment in the contract be reduced by the value of the refund feature, computed without discount for interest.[16]

To illustrate: if we assume that the cost of a refund annuity in the example above would be $15,000, then the investment in the contract must be reduced by $7,370.[17] The exclusion ratio is determined by dividing the reduced figure, $7,630 ($15,000 minus $7,370), by the life expectancy, 10 years, and the quotient is the amount ($763) to be excluded each year from gross income. The balance ($1,200 minus $763, or $437) is included in gross income.

Provisions in a contract for a minimum period of payments certain are within the concept of a "refund feature," under the new Code, but, in the case of an employee's annuity, payments to a beneficiary not attributable to contributions by the employee, are not part of the refund feature. Moreover, the Code recognizes that refund annuities may be held by more than one annuitant.

3. *Survivor Annuities*

Prior to 1951, survivorship annuities were rather heavily taxed, and as a result, only recently have they become popular. Customarily, sur-

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[13] I. T. 3140, 1937-2 Cum. Bull. 62.

[14] I. T. 3322, 1939-2 Cum. Bull. 177.

[15] INT. REV. CODE (1954) § 72(e)(A). *Cf.* Sen. Rep. No. 1622, 83rd Cong., 2d Sess. (1954) at p. 11: "Any refund paid to a beneficiary at the death of an annuitant is to be exempt from tax." [Italics ours.] Despite this language, the Code would seem to be referring to the return of capital rule. In the case of some retirement annuities having a refund feature, it is possible for the refund to exceed the consideration paid. In the case of single premium refund annuities, this is usaully not possible, and the refund will be "exempt" from tax.

[16] INT. REV. CODE (1954) § 72(c)(2).

[17] This figure is determined as follows: The discounted value of the refund feature is $4,100 ($15,000–$10,900). To this must be added the amount of interest attributable the contract for the period of the life expectancy, or $3,270 (3% of $10,900 x 10 years).

vivor annuities are of two types: the "self-and-survivor," where the annuity is paid to the annuitant for life, and at his death, to his beneficiary (usually, the annuitant's wife) for her life, and the "joint-and-survivor," where the annuity is paid on the joint lives of two annuitants, and on the death of the first annuitant, to the survivor. Since the joint lives involved are normally husband and wife, who are entitled to use income-splitting, there is no particular difference between the two types of contracts, for income tax purposes.[18]

Survivor annuities were formerly taxed under the three percent rule in much the same way as ordinary annuities. Thus, where a husband and wife purchased a single premium annuity, payable to the husband for his life, and at his death, to his wife for her life, it was held that the wife should continue to report her income under the three per cent rule after the death of her husband, until cost is finally recovered, when the full amount of the annuity became taxable.[19] A joint and survivor annuity was taxable to the husband so long as he was living, even though the wife may have put up part of the consideration. This was true whether the contract was worded as payable to husband *and* wife or husband *or* wife.[20]

As indicated in I. T. 3077, after the death of the first annuitant, the survivor continued to pay tax on three per cent of the *total* consideration. This problem was well illustrated by *Virginia M. MacArthur*.[21] In that case, the taxpayer and her mother purchased two annuity contracts for $25,000 each, or a total of $50,000. Each party contributed 50% of the consideration, and the annuities were made payable to the taxpayer's mother for life, and then to the taxpayer for life. The mother died, and the taxpayer reported as income three per cent of the cost of the two annuities which was allocable to the period of the taxpayer's life after the death of her mother. The Tax Court, however, held the taxpayer liable for three per cent of the total consideration for the annuities for the lives of both the taxpayer and her mother. On appeal, the taxpayer sought to show that the annuity contracts were severable as between herself and her mother. The Court of Appeals rejected this contention on the doctrines of both tax law and contracts law.[22]

The facts in *MacArthur* are an excellent illustration of bad planning. A wiser plan would have been to purchase an immediate annuity

[18]But, note that the expected return for a "self-and-survivor" and "joint-and-survivor" annuity is determined by means of different life expectancy tables. Tables II and IIA, T.D. 6118, *Supra,* Note 7.

[19]I. T. 3077, 1937-1 Cum. Bull. 136.

[20]I. T. 3092, 1937-2 Cum. Bull. 61. Since the advent of income splitting as between husband and wife, the question of whether an annuity should be taxed to the husband or not, is obviously not nearly so important as it was at the time of this decision.

[21]8 T. C. 279 (1947)

[22]MacArthur v. Commissioner, 168 F.2d 413 (8th Cir. 1948).

for the life of the mother, and a deferred annuity, to commence after the death of the mother, for the taxpayer. On the facts of the *MacArthur* case, the purchase of annuities of this type would have cost the taxpayer and her mother $246.88 more, a small price to pay for substantial tax advantages.

Fortunately, the harsh result of *MacArthur* was mitigated by Section 303 of the Revenue Act of 1951[23] which amended sections 22 (b) and 113 (a) (5) of the old Code. By this statute it was provided that, for taxable years ending after December 31, 1950, the cost basis of the survivor, for purposes of the three per cent rule, should be that provided by section 113 (a) (5). This section in turn provided that the survivor's interest in the annuity was to be regarded as "property acquired by bequest, devise, or inheritance" from the decedent, and hence, the basis of the annuity to the survivor would be fair market value at the date of death of the first annuitant, rather than cost to the original annuitant.

The new Code recognizes this method of taxation for joint and survivor annuities where the first annuitant died between December 31, 1950, and January 1, 1954. In section 72 (i) a number of special rules have been expressly stated in order to complete the statutory plan: (1) subsection (d) concerning employee's annuities, is inapplicable to these annuities;[24] (2) the basis to the surviving annuitant is fair market value as of the date of death of the decedent;[25] (3) amounts received by the surviving annuitant which are excludible from gross income should be deducted in determining the cost to be prorated over the life of the surviving annuitant;[26] (4) the annuity starting date is January 1, 1954, or the date the surviving annuitant first receives an amount under the contract, whichever is later.[27]

Another provision with respect to the income taxation of joint and survivor annuities is designed to prevent double taxation between the estate tax and the income tax of the survivor's share.[28] The original bill as it passed the House provided for an additional deduction to a survivor in a joint and survivor annuity based on the estate tax attributable to a portion of the basis of the annuity for estate tax purposes.[29] This section was moved to Section 691 by the Senate Finance Committee, on the theory that this was a problem involving the taxation of income with respect to decedents. In the words of the Senate Committee:

23P. L. 183, 82nd Cong., 1st sess., c. 521.
24INT. REV. CODE (1954) § 72 (i) (1).
25INT. REV. CODE (1954) § 72 (i) (2).
26INT. REV. CODE (1954) § 72 (i) (3).
27INT. REV. CODE (1954) § 72 (i) (4).
28INT. REV. CODE (1954) § 691 (d).
29H. R. 8300, 83rd Cong., 2d Sess. § 72 (j).

> The provisions [in Section 691] are designed to provide a deduction to the survivor based upon the estate tax attributable to a portion of the survivor annuity which represents the excess interest earned while the annuity was being received jointly. This is, in effect, income in respect of a decedent. This deduction will be spread ratably over the life expectancy of the survivor.[30]

4. *Amounts Not Received as Annuities*

The 1939 Code provided that "amounts received as an annuity under an annuity or endowment contract" should be subject to the three per cent rule, but no provision was made for any amounts which might be received under the contract that were not annuity payments. For example, if the taxpayer's contract was the typical retirement annuity type contract, he might receive a "dividend" subsequent to maturity, in addition to his annuity payment; or he might, under certain options available in the contract, elect to receive a lump sum payment. In each case, it was left to the case law to determine how these payments should be taxed. They were obviously not taxable under the three per cent rule, since not received "as an annuity."

Dividends paid to the annuitant after the full consideration for the contract had been paid, were taxable in full as ordinary income.[31] On the other hand, dividends paid the annuitant before he completed paying in the full consideration for his contract which he used to pay additional premiums, would not be taxable at the time of receipt, but would go to reduce his cost basis.[32] If the annuitant elected to take the proceeds of the policy or the cash surrender value either in a lump sum or in installments, he would not be taxed until he had first recovered his cost.[33]

The new Code largely codifies this case law. The basic rule is stated simply: if any amount not received as an annuity is received on or after the annuity starting date, it is includible in gross income;[34] if received before that date, it is includible only if the annuitant has first recovered his cost.[35] Dividends are specifically mentioned in the statute as being "amounts not received as an annuity."[36]

Any amount received "in the nature of a refund of the consideration paid," or on "the surrender, redemption, or maturity" of a con-

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[30]83rd Cong., 2nd sess., Senate Rep. No. 1622 (1954), p. 89.
[31]Florence May Shelley, 10 T. C. 44 (1948) (contract provided that taxpayer would "participate in the divisible surplus" of the company).
[32]I. T. 3413, 1940-2 Cum. Bull. 58.
[33]Reg. 118, Sec. 39.22 (b) (2)-1 and -2; George H. Thornley, 2 T.C. 220 (1943).
[34]INT. REV. CODE (1954) § 72 (e) (1) (A).
[35]INT. REV. CODE (1954) § 72 (e) (1).
[36]INT. REV. CODE (1954) § 72 (e) (1).

tract is expressly stated to be an amount "not received as an annuity."[37] Such amounts are includible in gross income if the annuitant has first recovered his cost, regardless of whether received before or after the annuity starting date.[38]

If the annuitant receives a lump sum, then the amount of the tax on any recovery in excess of cost is limited by whatever the aggregate taxes would have been if the lump sum were treated as though received in the taxable year and the two preceding taxable years.[39]

5. *Option to Receive Annuity in a Lump Sum*

Under the old Code, if the taxpayer had a contract which provided for the payment of a lump sum at maturity, but with an option to take an annuity, and he exercised such option *after* maturity, he was deemed to have constructively received the lump sum, which in turn was treated as though reinvested in an annuity.[40] He would thus be taxed on a return of capital theory to the extent that the lump sum exceeded his cost, and in addition, he would be subject to the three per cent rule in so far as the taxation of the annuity was concerned.[41] The new Code eliminates this doctrine of constructive receipt, provided the taxpayer makes his election to receive an annuity within 60 days after the maturity of the contract.[42]

6. *Interest*

Under the old Code, if the taxpayer elected to leave the proceeds of an annuity or endowment policy with the insurer, and draw down only the interest on the proceeds, such interest would be taxable in full as ordinary income.[43] The new Code retains this method of taxing such interest.[44]

Similarly, payments under a "Life Annuity with Death Benefit" are taxable in full as payments of interest on an invested fund. Under this type of contract, the taxpayer pays a single premium to the insurer and receives in return an "annuity" plus a promise to pay a lump sum

[37]"Any amount received, *whether in a single sum or otherwise*, under the contract which is in the nature of a refund of the consideration paid for the contract," shall be treated as an amount not received as an annuity. INT. REV. CODE (1954) § 72 (e) (2) (A). The italicized portion of the sentence was inserted by the Senate Finance Committee. This amendment was apparently inserted to make it clear that a refund under a typical refund annuity contract is taxable on a return of capital theory. Cf.: *supra*, note 12.

[38]INT. REV. CODE (1954) § 72 (e) (2).

[39]INT. REV. CODE (1954) § 72 (e) (3).

[40]Such constructive receipt worked only against the taxpayer, and not in his favor. If the taxpayer's cost exceeded the lump sum, he was not entitled to deduct any loss. 1 P-H Tax Serv. ¶ 8224 (1954).

[41]I.T. 3963, 1949-2 Cum. Bull. 36; Constance C. Frackelton, 46 B.T.A. 883 (1942), acq. 1944 Cum. Bull. 10.

[42]INT. REV. CODE (1954) § 72 (h).

[43]Blum v. Higgins, 150 F.2d 471 (2d Cir., 1945).

[44]INT. REV. CODE (1954) § 72 (j).

in the event of his death. While the contract has all the appearances of a life insurance contract plus an annuity, actually it is neither,[45] since the company issuing the policy takes no risk. Should the insured fail to live to his life expectancy, the company will lose on its "life insurance" policy but gain on the "annuity;" on the other hand, if he should live beyond his life expectancy, the company will lose on the "annuity," but gain on the "life insurance." A physical examination is not required for this type of policy and the return on the policy is not computed with reference to mortality tables.

Accordingly, despite a Court of Appeals holding to the contrary,[46] the Commissioner in 1940 ruled that such a contract was not a life insurance or annuity contract, but a contract for the payment of interest or earnings on a fund. Any payments under the contract would, therefore, be fully taxable as ordinary income.[47] The Sixth and Eighth Circuits refused to follow the Commissioner's ruling,[48] but the Commissioner was finally successful in the Seventh Circuit.

In *Igleheart v. Commissioner,* the taxpayer purchased nine single premium "insurance" contracts, without the requirement of a medical examination, providing for payment of a fixed principal sum to the taxpayer upon his surrender of the policy, or to designated beneficiaries in the event of his death, and for annual payments to the taxpayer in the interim. The premiums for the contracts were computed without reference to any mortality tables, but were determined by adding a certain interest rate (five per cent in the case of seven of the contracts and six per cent in the case of two of them) to the principal sum. The Seventh Circuit held that the contracts were not annuities, and the annual payments were accordingly taxable in full as interest.

> Whether the payments to taxpayer are labeled "annuity payments" is not determinative of whether they qualify as such under [1939] Code Sec. 22 (b) (2). We think that these payments, which did not include any return of taxpayer's capital, do not so qualify. We hold that such payments are in fact nothing more than interest or earnings upon an invested fund.[49]

In all probability, payments under such an arrangement will continue to be taxable in full under the new section of the Code which reads as follows:

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[45]This is equally true whether the contract is, as a matter of form, concluded within one document or two separate documents, one of which purports to be a life insurance contract, and the other an annuity.

[46]Bodine v. Commissioner, 103 F.2d 582 (3rd Cir. 1939).

[47]G. C. M. 21716, 1940-1 Cum. Bull. 82, revoking G. C. M. 6395, 1929-1 Cum. Bull. 67.

[48]Commissioner v. Meyer, 139 F.2d 256 (6th Cir. 1943); Helvering v. Meredith, 140 F.2d 973 (8th Cir. 1944).

[49]174 F.2d 605, 606 (7th Cir. 1949).

Notwithstanding any other provision of this section, if any amount is held under an agreement to pay interest thereon, the interest payments shall be included in gross income.[50]

7. *Transfer of an Annuity*

Section 72 (g) of the new Code states the method of taxing an annuity contract in the hands of a transferee where the contract was acquired for a valuable consideration. In no case, however, can the transferee's basis be less than zero.[51] The transferee's investment in the contract is the total of any consideration paid the transferor plus any premiums paid subsequent to the transfer, minus any amounts received prior to the annuity starting date which were excludable from gross income. The annuity starting date for the transferee is January 1, 1954, or the first day of the first period for which he receives an amount under the contract as an annuity.[52]

If a transferor makes a gift of an annuity to a transferee, these rules are, of course, inapplicable. In that case, the basis of the annuity to the transferee is the basis for the annuity in the hands of the transferor.

B. Estate Taxation

The ordinary life annuity would normally not be includible in the gross estate of a decedent, since it would terminate upon the death of the decedent, and hence the decedent would have no interest at death. On the other hand, if the annuity is such that there is provision for payments after death—as in the case of the refund annuity, the annuity with a certain number of payments guaranteed, or the survivor annuity—there may well be an interest which would be includible in the decedent's gross estate.

Unlike the new Code, the 1939 Code had no special provision for the inclusion of annuities in the gross estate. Nevertheless, annuities were includible in the decedent's estate under various provisions of the Code. Under certain circumstances, annuities were includible under old Section 811 (a) as property in which the decedent had an interest at death.

1. *Property in Which the Decedent Has An Interest*

In *Millard v. Maloney*[53] an annuity for the life of another was included in the decedent's gross estate. If there is any portion of an annuity which has accrued to the decedent but has not been paid, the

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[50]Int. Rev. Code (1954) § 72 (j).
[51]Int. Rev Code (1954) § 72 (m), 1021.
[52]Sec. 72 (g).
[53]121 F.2d 257 (3rd Cir., 1941), cert. denied, 314 U.S. 636 (1941).

value of such accruals will be included in the gross estate.[54] Amounts due under employee annuities have also been held includible under old 811 (a).[55]

Despite these cases, the Commissioner has had difficulty in getting annuities taxed under old 811 (a), for the reason that the decedent normally does not have any "interest" in the property at death. The annuitant, for example, has no interest in a refund payable to his beneficiary under a refund annuity contract upon his death. This is true, regardless of the type of annuity.[56]

2. *Transfers With Retained Life Estate*

Having failed in his attempt to have annuities which survive the decedent included under old 811 (a), the Commissioner next sought to have these contracts taxed as *inter vivos* transfers. Prior to March 3, 1931, (the date of the joint resolution of Congress providing for the inclusion of transfers where the transferor retained a life estate), survivorship annuities were taxable only if the transferor retained a power of revocation or modification.[57]

Subsequent to that date, the Commissioner sought to have survivor annuities taxed as transfers in which the decedent retained a life interest.[58] The Commissioner was generally successful in the field of commercial annuities,[59] but in a series of cases involving employees' annuities it was held that the employee had no interest which would bring the annuity within the scope of the statutes.[60]

3. *Transfers Taking Effect at Death*

Where the retention of a life interest failed to bring the survivor

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[54]4-A P-H Fed. Tax Serv. ¶ 123,242 (1954); but cf. Annie T. Stinchfield, P-H TC Memo ¶ 45,168 (1945) rev'd and remanded to decide other issues of fact, 161 F.2d 555 (9th Cir. 1947) (payment on date of death held not apportionable, and therefore not includible in decedent's gross estate). INT. REV. CODE (1954) § 2033.

[55]Estate of William L. Nevin, 11 T. C. 59 (1948) (balance due under contract terminating decedent's employee paid to his widow); Kernochan v. U. S., 89 Ct. Cl. 507, 29 F. Supp. 860 (1939), cert. denied, 309 U. S. 675 (1940); Estate of Emil A. Stake, 11 T. C. 817 (1949) *semble*.

[56]Estate of Susie C. Haggett, 14 T. C. 325 (1950), non-acq. 1950-2 Cum Bull. 5.

[57]Hariot Reynolds Schultz, 38 B.T.A. 59 (1939) acq. 1939-1 Cum. Bull. 29; INT. REV. CODE (1939) § 811 (d); INT. REV. CODE (1954) § 2038.

[58]INT. REV. CODE (1939) § 811 (c) (1) (B); INT. REV. CODE (1954) § 2036; Reg. 105, § 81.18.

[59]Maerkle's Estate v. Commissioner, 129 F.2d 238 (3rd Cir. 1942), affirming 45 B.T.A. 894 (1941); Commissioner v. Close, 122 F.2d 998 (9th Cir. 1941), reversing 41 B.T.A. 820 (1940); Commissioner v. Wilder's Estate, 118 F.2d 281 (5th Cir. 1941), reversing 41 B.T.A. 1344 (1940); U.S. Trust Co. v. Higgins, 56 F. Supp. 997 (S.D.-N.Y. 1942); Estate of Welliver, 8 T.C. 165 (1947). Where decedent purchases a combination single premium life insurance policy and life annuity, and immediately assigns the insurance policy to the beneficiaries thereof, he makes a transfer with a life estate retained. Rev. Rul. 54-552, Int. Rev. Bull. 1954-48, p.25; *cf*: Harrison v. Bohnen, 345 U.S. 946 (1953).

[60]Commissioner v. Twogood's Estate, 195 F.2d 627 (2d Cir. 1952) affirming 15 T.C. 989 (1950); Higgs' Estate v. Commissioner, 183 F.2d 427 (3rd Cir. 1950), reversing 12 T.C. 280 (1949); Estate of Howell, 15 T.C. 224 (1950).

annuities into the gross estate, the Commissioner sought to have them included as transfers intended to take effect in possession or enjoyment at or after death. In *Cowles v. United States*,[61] the decedent procured an insurance policy for the purpose of paying his wife, whom he was about to divorce, $200 monthly, for the rest of her life, the payments ot begin at his death. The Second Circuit held that such an annuity was not a transfer effective at death. In *Pruyn's Estate v. Commissioner*,[62] the Commissioner sought to tax as a transfer to take effect at death a survivor annuity which could not be reached as a transfer with life interest retained, as the contract had been made prior to 1931. The Court held, however, that it was not includible under old 811 (c) (2), as no reversionary interest had been retained by the transferor.

As for employees' annuities, the Commissioner has had no more success getting them included in the taxpayer's gross estate as transfers intended to take effect in possession or enjoyment at or after death than he had on the theory of retention of a life interest. Despite the Commissioner's ruling to the contrary, the Tax Court has held that payments to a widow under an employee pension plan are not includible in the employee's gross estate as a transfer intended to take effect at death.[63]

4. *Other Points*

(1.) Refund and survivor annuities are not "life insurance" and, therefore, are not taxable under old Section 811 (g) (new Section 2042).[64]

(2.) A number of different methods of valuation have been used for purposes of determining the value of a survivor annuity in the estate of a decedent. They are as follows:

a. the cost of comparable contracts[65]

b. replacement cost[66]

c. cash surrender value plus dividends on depsit[67]

(3) If the optional valuation date is used, the value of a survivor

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[61]152 F.2d 212 (2nd Cir. 1945), reversing 59 F. Supp. 633 (S.D.N.Y. 1945).

[62]184 F.2d 971 (2d Cir. 1950).

[63]Estate of William S. Miller, 14 T.C. 657 (1950), non-acq. 1950-2 Cum. Bull. 6, affirmed per stipulation, Commissioner v. Estate of Miller, 181 F.2d 85 (5 Cir. 1951), P-H ¶ 71, 104 (7th Cir. 1951); Estate of Frank M. Gordon, P-H Memo TC ¶ 50,130 (1950), affirmed per stipulation, Commissioner v. Estate of Gordon, —F.2d—, (1951), P-H ¶ 71,104 (7th Cir. 1951), *cf.* Letter of Deputy Commissioner Bliss, dated Dec. 2, 1953, affirmed by letter of Commissioner Nunan, dated Oct. 9, 1946.

[64]Guaranty Trust Co. of N.Y., Executor, 16 B.T.A. 314 (1929); Old Colony Trust Co. v. Commissioner, 102 F.2d 380 (1st Cir. 1939), affirming 37 B.T.A. 435 (1938); Estate of Frank J. Saxe, 37 B.T.A. 535 (1938) non-acq. 1938-2 Cum. Bull. 57; Schultz' Estate, P-H Memo B.T.A. ¶ 39,282 (1939).

[65]Reg. 105, § 81.10; Maerkle's Estate v. Commissioner, *supra*, note 57; Judson C. Welliver, 8 T.C. 165 (1947).

[66]U.S. Trust Co. of N. Y., Exec. v. Higgins, 56 F. Supp. 997 (D.N.Y. 1942).

[67]Wishard, Jr., Exec. v. U. S., 143 F.2d 704 (7th Cir. 1944).

annuity is determined as of the date of death, since it is a difference in value determined by a "mere lapse of time."[68] But, if the surviving annuitant should die prior to the optional valuation date, then the loss of value due to such death is excluded from the gross estate, and the date-of-death value must be adjusted to reflect the occurrence of this contingency.[69]

5. *Annuities*

In the 1954 Code, a new section has been inserted with specific reference to the problem of annuities. Section 2039 requires the inclusion in the decedent's gross estate of the value of any annuity or other payment to which the beneficiary is entitled by reason of surviving the decedent, under any contract made after March 3, 1931. Only the value of the survivor's right to the annuity is includible. This is, in effect, a codification of the rule of old Section 811 (c) (1) (B) as specifically applied to annuities. But the new Code further provides that the amount includible is limited to the survivor's right to the annuity attributable to the consideration furnished by the decedent.[70]

This provision should encourage the use of survivor annuities in estate planning. A man of property, for example, may find it advantageous to purchase a joint-and-survivor, or self-and-survivor, annuity as part of an estate plan for himself and his wife. Such an annuity will be taxed, for income tax purposes, under the favorable annuity rule. If the husband furnishes all the consideration, and is survived by his wife, there will be included in his gross estate that portion of the annuity which represents the value of her right to the annuity after his death, but since this portion normally qualifies for the marital deduction, no estate tax will be due with reference to the annuity.

The new Code does change the prior law to the extent that it provides that contributions by a decedent's employer to an employees' pension or profit-sharing plan shall be deemed to have been contributed by the employee, if made by reason of his employment. However, if the particular plan is qualified under Section 401, then any payments to the surviving beneficiary are wholly excluded from the employee's gross estate.[71]

C. *Gift Taxation*

The new Code does not contain any special provision with respect to the gift taxation of annuities. An annuity contract may, of course, be

[68]INT. REV. CODE (1939) § 811 (j): INT. REV. CODE (1954), § 2032; Estate of Judson C. Welliver, 8 T.C. 165 (1947).

[69]Estate of John A. Hance, 18 T.C. 499 (1952), acq. 1953 P-H FED. TAX SERV. ¶ 76.370.

[70]INT. REV. CODE (1954) § 2039 (b).

[71]Section 2039 (c).

the subject of a gift, and if transferred for less than an adequate and full consideration in money or money's worth, the value of the contract as of the date of the gift is subject to the gift tax, to the extent that such value exceeds the value of any consideration received. Similarly, under appropriate circumstances, the value of the contract might be included in the decedent's gross estate under Section 2035 where it was the subject of a gift in contemplation of death.

II. Private Annuities

Private annuities arise where the annuitant-transferor transfers property to a person or institution in exchange for a promise of the latter to pay him an annuity. Usually the transferor is a person of some property who is anxious to get a steady income for the rest of his life, be relieved of the responsibilities of managing property, and at the same time satisfy his objectives with respect to the distribution of his property. The transferee is usually a member of the transferor's family or a charity. In either case, an arm's length transaction may be involved, bringing into play the income tax doctrines of gain or loss on the exchange of property. Since the value of the property transferred often exceeds the value of the annuity obligation, the transfer may be for less than an adequate and full consideration in money or money's worth, and the gift tax may also be involved. Moreover, under certain circumstances, a transfer may be includible in the gross estate of the transferor for estate tax purposes. It is thus apparent that any number of tax situations can arise on the exchange of property for an annuity: (1) income tax consequences to the transferor-annuitant; (2) income tax consequences to the payor-transferee; (3) gift tax consequences to the transferor-annuitant; and (4) estate tax consequences to the transferor-annuitant.[72] In the discussion that follows, we shall consider how each of these tax situations have been handled in the past, and how they will be treated under the new Code.

A. *Income Tax Consequences to the Annuitant-Transferor*

In considering the income tax consequences to the annuitant-transferor, we are faced with two problems: (1) to what extent is the transferor taxed at the time of the exchange on the transfer of the property in exchange for the transferee's promise to pay him an annuity? (2) how should the annuity payments be taxed to the transefor at the time he receives them?

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[72]Logically, it might also be contended that the payor-transferee who received property of a value very much less than the value of the annuity which he gave the transferor might be making a transfer for less than an adequate and full consideration in money or money's worth, which would become a completed gift as the payor of the annuity made payments on his obligations. But since, as a practical matter, if there is any difference in values, the value of the property transferred is invariably greater than the value of the annuity obligation, we can disregard this tax possibility.

1. *Taxation of the exchange*

The earliest cases, and rulings held that the annuitant-transferor would not realize any income until the payments under the contract exceeded the value of the property transferred.[73]

In *J. Darsie Lloyd*, the Commissioner sought to tax the transferor on the exchange of securities for a promise to pay an annuity, to the extent that the fair market value of the annuity promise received exceeded the transferor's basis with respect to the securities transferred.

Recognizing that the transferor would realize income once the annuity payments exceeded the transferor's basis, the Board of Tax Appeals held that no income was realized on the exchange, since the promise of an individual, unlike that of an insurance company or bank,[74] to pay an annuity has no fair market value.[75] This was true even though the promisor involved in the case was Harold Lloyd, the comedian, one of the wealthiest and most solvent men of his time. Said the Board:

> The fair cost of an annuity based upon experience tables giving life expectancies can be determined by actuaries. A similar method would have to be used to estimate the present value of an annuity to the annuitant. But here a new element enters the computation, the uncertainty as to whether or not the one agreeing to make payments will be able to make them as agreed when the time for payment actually arrives . . . The evidence shows that the contract . . . had no fair market value within the meaning of section 111 (c) [of the Revenue Act of 1928] when received by the petitioner of April 16, 1930.[76]

Ever since its decision, *Lloyd* has been consistently followed, and

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[73]I. T. 1363, I-1 Cum. Bull. 79 (1922); G.C.M. 1022, *VI*—1 Cum. Bull. 12 (1927); Continental Illinois Bank & Trust Co. v. Blair, 45 F.2d 354 (7th Cir. 1930). Sometimes an agreement which, on its face, seemed to involve a transfer of property in exchange for an annuity, would be held to be a transfer in which the transferor retained a life interest. In such a case, the income from the property would be fully taxable to the grantor as ordinary income. I.T. 1220, I—Cum. Bull. 79 (1922) (transfer of securities to charity which was to pay income therefrom to donor not exceeding a certain percent per annum); Michael Fay, 34 B.T.A. 662 (1932) (transfer of securities to charities who were to pay the income therefrom, after deducting taxes, to transferor, for life, then to his wife for life if she survived him) Cf. Comm'r. v. Kann's Estate, 174 F.2d 357 (3rd Cir. 1949) (dissent on theory that exchange of property for an "annuity" should be treated as a retention of a life estate).

[74]Seaman v. U.S., 156 F.2d 719 (7th Cir. 1946). *Cf.* Guaranty Trust Co. of N.Y. 15 B.T.A. 20 (1929).

[75]In so holding, the court followed the leading case of Burnet v. Logan, 283 U.S. 404 (1931).

[76]33 B.T.A. 903, 905 (1936) non-acq. XV-2 Cum. Bull. 39 (1936), acq. 1950-2 Cum. Bull. 3. (non-acq. withdrawn).

the courts have uniformly ruled that no gain[77] or loss[78] is realized on the exchange of property for the annuity promise of an individual.

2. *Taxation of Annuity Payments Under the Three Percent Rule*

Had the return of capital theory been followed in the taxation of annuities, it is conceivable that no problem would have arisen as to the taxation of the payments until the annuitant-transferor had recovered his cost for the property transferred; but after the amendment of 1934 the Commissioner sought to tax the payments under the three per cent rule of the new statute, and was generally successful.[79] Difficulty arose, however, with respect to the determination of what constituted the "consideration paid," for purposes of applying the new rule. If *Lloyd* had been consistenly followed, the annuity payments would not have been taxable until cost had been recovered, since three per cent of zero would be zero. Alternatively, it might have been held that it was not intended that the three per cent rule should affect private annuities. The Committee reports seem to indicate that Congress was concerned only with commercial annuities.[80] The courts, however, held that the three per cent rule applied, and used a number of different methods for measuring the "consideration paid": (1) the value of a comparable commercial contract;[81] (2) the fair market value of the property transferred,[82] or (3) the present value of future payments expected, based on the estate and gift tax actuarial tables.[83] These rules also had a complementary aspect: for example, if the value of the property transferred greatly exceeded the cost of a comparable commercial contract or the commuted value of the annuity payments, such excess might be properly treated as a gift.[84]

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[77]Commissioner v. Estate of Kann, 174 F.2d 357 (3d Cir. 1949), *affirming* 6 T.C.M. 913 (1947) no cert. 1949 P-H ¶ 71,090; Bella Hommel, 7 T.C. 992 (1946) non-acq., 1947-1 Cum. Bull. 5, acq. 1950-2 Cum. Bull. 3 (non-acq. withdrawn); Frank C. Deering 40 B.T.A. 984 (1939); see Rev. Rul. 239, 1953-2 Cum. Bull. 53, 54.

[78]Evans v. Rothensies, 114 F.2d 948 (3d Cir. 1940) (no deductible loss on the transfer of securities in exchange for an annuity, although fair market value of annuity contract much less than transferor's basis); *see* Frank C. Deering, 40 B.T.A. 984, 987 (1939); *accord,* B.T.A. 1200 (1934); I.T. 2915, XIV-2 Cum. Bull. 98 (1935).

[79]Anna L. Raymond, 40 B.T.A. 399 (1941), 114 F.2d 140 (7th Cir. 1940), *cert. denied,* 311 U.S. 710 (1940); Elizabeth L. Beattie, 6 T.C. 609, 1946, affirmed sub. nom. Beattie v. Commissioner, 159 F.2d 788 (6th Cir. 1947); Maud Gillespie, 43 B.T.A. 399 (1941), *rev'd. on other grounds,* Gillespie v. Exec. Commissioner, 128 F.2d 140 (9th Cir. 1942); F. A. Gillespie, 38 B.T.A. 673 (1938) affirmed sub. nom. Gillespie v. Commissioner, 154 F.2d 903 (10th Cir. 1945); Estate of Hill v. Maloney, 58 F. Supp. 164 (D.N.J. 1944); *accord,* Ware v. Comm'r., 159 F.2d 542 (5th Cir. 1949), *But cf.* Lydia Hopkins, 13 T.C. 952 (1942), appeal dismissed, Comm'r. v. Hopkins,—F.2d—(1950) P.H. Fed. Tax Serv. ¶ 71,098 (9th Cir. 1950), non-acq., 1950-1 Cum. Bull. 7.

[80]H. R. Rep. No. 704, 73rd Cong. 2d sess. 21 (1934); Sen. Rep. No. 558, 73rd Cong. 2d Sess. 591 (1934).

[81]Ann L. Raymond, *supra,* note 78; Maud Gillespie, *supra,* note 79; *cf.* Estate of Kann, *supra,* note 77; F. A. Gillespie, *supra,* note 79.

[82]Elizabeth L. Beattie, *supra,* note 79; F. A. Gillespie, *supra,* note 79; *Cf.* Estate of Hill v. Maloney, *supra,* note 79. The Commissioner has adopted this rule. Rev. Rul. 239, 1953-2 Cum. Bull. 53, 54.

[83]Edmund A .Steenburg, P-H BTA Memo. ¶ 41,184; see G.C.M. 19,168, 1932-1 Cum. Bull. 17; *cf.* Estate of Sarah A. Bergen 1 T.C. 543 (1943) acq., 1943 Cum. Bull. 2; Lydia Hopkins, 13 TC 952 (1949), (dissenting opinion).

[84]Anna L. Raymond, *supra,* note 79; Estate of Sarah A. Bergen, *supra,* note 83.

In one case, the court was unable to find any basis for the application of the three per cent rule, and held that the taxpayer would not be liable until there had been a recovery of capital. In this case, the taxpayer, who had a disagreement with her mother with reference to her father's estate, entered into a settlement in 1936, whereby she agreed to release rights valued at $254,000 in exchange for her mother's promise to pay her an annuity. The Commissioner sought to tax the entire amount of the annuity payments on the theory that the taxpayer had failed to prove any basis for purposes of determining what portion should be excluded from gross income under old Section 22(b)(2). The court, however, held that any rights which the taxpayer had released were "highly contingent"; by so holding, the Board apparently treated the value of the "consideration paid" by the annuitant (i.e., the release of any claims against her mother's and father's estates) as zero, and that she could, therefore, not be taxed until she had recovered her capital.[85]

3. *Taxation of Annuity Payments After There has been a Recovery of Capital*

On the whole, the Commissioner was successful in his attempt to tax annuity payments under the three per cent rule. The question remained whether, once the taxpayer had recovered his cost, he would be taxed to the extent that the fair market value of the annuity payments exceeded his basis, and if such excess were taxable, whether it should be treated as ordinary income or capital gain.[86]

In *Estate of Hill v. Maloney*[87] the taxpayer made a contract with a syndicate whereby he agreed to transfer stock in exchange for a down payment, and a promise to pay the taxpayer an annuity for the rest of his life. The stock had a basis to the taxpayer of $50 per share, and a fair market value of $400 per share. The taxpayer reported, on his income tax return, capital gain to the extent that the fair market value of the stock exceeded his basis. The Commissioner asserted a deficiency on the theory that (1) the taxpayer's basis should have been $43 per share for purposes of determining gain, and (2) the taxpayer should have reported taxable annuity income of $4,590 for the year 1936. The taxpayer paid this deficiency and then sued in the District Court for a refund, claiming that there could be no realization of income until he had first recovered his capital. The defendant Collector defended the suit on the

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[85]Lydia Hopkins, 13 T.C. 952 (1949) non-acq., 1950-1 Cum. Bull. 7. The dissent was quick to point out the inconsistency in the Court's opinion which treated the rights as highly contingent, and yet gave them a value of $254,000 for purposes of the recovery of capital doctrine.

[86]"Basis" in this context is quite different from the "consideration paid" for purposes of applying the three percent rule. Here, we speak of basis in connection with the sale or exchange of property. Normally, such basis will be the cost of the property transferred.

[87]58 F. Supp. 164 (D.C.N.J. 1944). The Commissioner has announced his intention to follow this case. Rev. Rul. 239, 1953-2 Cum. Bull. 53.

theory that the "sale" of the 900 shares was not a *bona fide* sale, but a gift, with a life estate retained. Accordingly, he argued the taxpayer should be taxed as he receives income from this property at ordinary income rates.

The court held: (1) the contracts were a normal business transaction, and not a gift; (2) the promise to pay an annuity had no fair market value; (3) the amount received by the taxpayer by way of the down payment or annuity payments over and above his basis of $43 per share is taxable as capital gain; (4) the amounts received as an annuity are taxable under the three per cent rule.[88] The anomalous result of double taxation of the annuity was justified by the somewhat specious reasoning that if the taxpayer had sold his stock at fair market value and used the proceeds to buy an annuity, he would have been similarly taxed.

4. *Effect of H. R. 8300*

Prior to the enactment of the new Code, it was clear from the case law that the annuitant-transferor would realize no gain or loss upon the exchange of property for an annuity. On the other hand, annuity payments were taxable to him under the three per cent rule, and might also be taxed as capital gain where they represented a recovery in excess of the annuitant's basis. Confusion as to what constituted the "consideration paid" for purposes of old Section 22 (b) (2), as well as the double taxation problems indicated by *Hill's Estate* prompted the House Ways and Means Committee to include in the original version of the new Code[89] a new section[90] devoted to the income taxation of private annuities. The new section overruled *J. Darsie Lloyd,* and provided that gain or loss should be recognized on the exchange of property for an annuity promise of an individual. For purposes of determining the amount realized by the transferor, the value of the annuity promise was to be determined by comparison with a comparable commercial contract, without regard to the financial condition of the particular obligor.[91] To the extent that the value of the property transferred exceeded the value of the annuity, the transferor would be deemed to have made a taxable gift.[92] For purposes of applying the annuity rule of Section 72, the value of the annuity would be deemed the "amount of premium and other consideration paid" for the contract.[93] If the annuitant-transferor subsequently received a commercial annuity in exchange for the private annuity, he would continue to be taxed as under

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[88]In determining the figure to be used for purposes of the three percent rule, the Court apparently used the fair market value of the stock less the down payment made at the time of the transfer.

[89]H. R. 8300, 83rd Cong., 2d sess. (1954).

[90]H. R. 8300, § 1241; *cf.* A.L.I., Fed. Income Tax Statutes XI 26.

[91]H. R. 8300, § 1241 (a) (1); House Rep. No. 1337, 83rd Cong., 2d sess., A286.

[92]Ibid., A286.

[93]H. R. 8300, § 1241 (a) (1) *cf.* INT. REV. CODE, 1954, §72 (c) (1).

the private annuity.[94]

The original version of the Code thus contained an excellent solution to the troublesome problem of private annuities. Unfortunately, as the law was finally enacted, this section was not included, having been eliminated by the Senate Finance Committee.

In its Report, the Committee said:

> The objective of clarifying the uncertainty of the court decisions is praiseworthy. It was found, however, that the application of the rules of the House Bill left some uncertainty in particular areas, notably in support contracts. It was considered preferable to give more attention to the operation of the proposed new rules in various types of situations before they were adopted.[95]

The effects of the elimination of the proposed Section 1241 from H. R. 8300 can be best understood by considering an example: Assume a man, T, aged 65, with a life expectancy of ten years, owns Blackacre, with a basis to T of $100,000, a fair market value of $250,000, and an annual income to T of $12,000. Assume further that a comparable commercial annuity would cost $109,000. T desires to leave his property to the X Charity, free himself of management responsibilities, and be assured of an equivalent income for the rest of his life. Accordingly, he transfers Blackacre to the X Charity in exchange for a promise to pay him an annuity of $12,000 a year for the rest of his life.

Had Section 1241 of the House Bill been included in the new Code, T would have realized a capital gain of $9,000 (fair market value of the annuity, $109,000 minus T's basis, $100,000) on the exchange. For purpose of the gift tax, T would have made a gift in the amount of $141,000 (fair market value of Blackacre, $250,000 minus fair market value of the annuity, $109,000), which would have been fully deductible for gift tax purposes since the gift is to a charity. Finally, under the new annuity rule, $10,900 [$109,000 divided by ($12,000 x 10) x $12,000] of each annuity payment would be excluded from gross income, leaving $1,100 to be included in T's gross income for the rest of his life. Thus, if T lived to his life expectancy, he would report the following amounts as income:

Capital gain on the exchange	$ 9,000
Taxable income from annuity ($1,100 x 10)	$11,000

94H. R. 8300, § 1241 (a) (2) *cf.* Seaman v. U.S., Note 73 *supra,* (realization of income on exchange of private annuity for commercial annuity).

95Sen. Rep. No. 1622, 83d Cong., 2d sess. 116 (1954) (presumably, by "proposed new rules" the Committee had in mind the operation of the annuity rules under Section 72).

The failure to enact Section 1241 of the House Bill means that *J. Darsie Lloyd*[96] is still good law with respect to the non-taxability of the exchange. On the other hand, the enactment of Section 72 of the new Code has made the annuity payments taxable under the new rule.[97] But, again, difficulty arises in determining what constitutes the "amount of premiums of other consideration paid"[98] for purposes of applying the new rule. Under the three per cent rule of the old Code, the larger this amount was, the greater the amount the annuitant would have to report as taxable income. Under the new rule, the reverse is true: the larger the consideration, the less each annuity payment would be taxed. The difference in operation of the two rules can be seen from the following table, showing how much is included in gross income out of each annuity payment, depending upon what figure is said to be the "consideration paid" for purposes of applying the rule:

	Consideration	Amount Includible Old Code	New Code
(a) Fair market value of Blackacre	$250,000	$7,500	Zero ($25,000 is excluded)
(b) Commuted value of a $12,000 annuity	114,583	3,437	$ 542
(c) Cost of comparable commercial annuity	109,000	3,270	1,100
(d) Basis of Blackacre to T	100,000	3,000	2,000
(e) Zero	Zero	Zero	12,000

Under these circumstances, it may be expected that the Commissioner will argue that, following *J. Darsie Lloyd,* nothing is realized on the exchange and, accordingly, when the exclusion ratio of Section 72 is calculated, the "investment in the contract" is zero, with the result that no part of the annuity payments can be (see situation (e) in example above) excluded from gross income. To reach this result, however, the Commissioner will have to upset a large body of precedent which has consistently rejected this argument. A more likely result would be for the Tax Court to hold that, for purposes of applying the annuity rule of Section 72, the "consideration paid" should be deemed to be the commuted value of the annuity promise or the cost of a comparable commercial contract.

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[96]It is of course possible that the Tax Court might yet overrule J. Darsie Lloyd and hold that gain should be recognized on the exchange.

[97]It might also be argued that the Code was not intended to affect private annuities. In view of the comments of the Senate Finance Committee, however, it is doubtful if such an argument would be successful.

[98]INT. REV. CODE (1954) § 72 (c) (1).

The problem remains whether T will be taxed on the return of capital once he has recovered his basis by way of the annuity payments. The Commissioner might contend that, regardless of the method of taxing the annuity payments under Section 72, T would realize gain as soon as the amount of the annuity payments exceeded his cost basis.[100] In the example above, this would mean that in the ninth year in which T receives annuity payments, he would realize $8,000 gain, and in the tenth, and all subsequent years, he would realize a $12,000 gain.[101]

A more plausible contention would be to the effect that once the taxpayer had recovered his cost by way of tax-free recovery, he would be taxed on any gain which he received over and above his basis. In the example above, this would mean that T would realize no gain for the first eight years of the annuity payments, but would realize gain in the ninth and subsequent years depending upon the method of measuring the "consideration paid" for purposes of the annuity rule:

	9th Year	10th Year	11th and Subsequent Years
(a) Fair market value	$8,000	$12,000	$12,000
(b) Commuted value of $12,000 annuity	3,122	12,000	12,000
(c) Cost of comparable commercial annuity	Zero	9,000	12,000
(d) Basis of Blackacre to T	Zero	Zero	12,000
(e) Zero	Zero	Zero	Zero

In order to sustain either of these contentions, however, it would be necessary for the Tax Court to overlook the logical inconsistency of taxing the same payments under both Section 72 and as a return of capital. While *Hill's Estate* lends support to this position, it ignores the fact that the very purpose of the new annuity rules is to secure an even method of taxation over the life of the annuitant.

The most likely result would seem to be for the Tax Court to adhere to its decision in *J. Darsie Lloyd*, and tax only the annuity payments under Section 72, using either the cost of a comparable commercial contract or the commuted value of the annuity promise as the "amounts of premiums or other consideration paid for the contract." Alternative solutions would be: (1) to overrule *J. Darsie Lloyd* and tax the exchange of the property for the annuity, as well as the annuity payments; (2) to tax the annuity payments in full, on the theory that the consideration paid was zero; (3) to treat private annuities as not subject to Section 72, and tax the payments only after the taxpayer has recovered

[100]Hill's Estate v. Maloney, *supra*, note 78.

[101]Quare: Should such gain be treated as capital gain or ordinary income? *See* Ware v. Comm'r., 159 F.2d 542 (5th Cir. 1947) (payments held to be taxable under annuity rules, and not as capital gains); *but see* Hill's Estate v. Maloney, *supra*, note 79.

his capital; (4) to tax the annuity payments under both the annuity rule and as a recovery of capital. For reasons stated above, it is doubtful that any of these alternatives will be accepted.

B. *Income tax consequences to the payor-transferee*

1. *The basis of the property acquired*

From the point of view of the payor-transferee, a private annuity transaction might be viewed as either (1) a *purchase* of the property, (2) a *sale* of the annuity, or (3) an *exchange* of the property for the annuity. If viewed as a purchase, the payor-transferee will have no immediate income tax problems other than the calculation of his basis for purposes of depreciation or a subsequent disposition of the property. If viewed as a sale or exchange, he would realize gain or loss, depending upon whether the fair market value of the property exceeds, or is less than, his basis for the annuity. If so treated, his new basis would be the fair market value of the property at the time of acquisition.

The majority of cases treat the transaction as a purchase by the payor-transferee. As such, his basis can be readily determined by the aggregate of the payments made, provided he has fulfilled his obligations under the annuity contract.[102] Difficulty arises, however, where the annuitant is still living. In *Nelson Trottman*,[103] the taxpayer's mother assigned a contract to the taxpayer, giving him the right to a percentage of the earnings of a corporation for an eight-year period, in exchange for the taxpayer's promise to pay her an annuity of $1,800 a year. In 1940, the taxpayer received income in the amount of $10,906.15 under the assigned contract. In order to determine the portion of this amount which was includible in the taxpayer's gross income, it was necessary to find his basis for the contract. This the court did by discounting the aggregate of all payments to be made under the annuity contract, considering the mother's life expectancy.[104]

In one case, the court treated a private annuity transaction as the sale of an annuity by the payor-transferee. Accordingly, the transferee's basis for depreciation purposes was held to be the fair market value of the property transferred, rather than the cost of the annuity contract measured by the annuitant's life expectancy.[105]

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[102]E.g., in D. Bruce Forrester, the Tax Court said: "The question is simply petitioner's cost. He paid out $34,500 under his agreement and the final payment discharged his liability for all time. His actual outlay [rather than $39,646.50, the amount he would have had to pay a standard life insurance company for a like annuity] of $34,500 constitutes his cost." 4 T.C. 907, 916.

[103]P-H Memo T.C. ¶ 44,112 (1944).

[104]*Accord*, G.C.M. 11,655, XII-1 Cum. Bull. 12 (1933), modifying O.D. 945, 4 Cum. Bull. 44 (1921); Steinbach-Kresge Co. v. Sturgess, 33 F. Supp. 897 (D.N.J. 1940) (cost of stock acquired by transferee determined by multiplying the amount of the annual payment by the annuitant's life expectancy).

[105]John C. Moore Corp., 15 B.T.A. 1140 (1929), aff'd. sub. nom. Commissioner v. John C. Moore Corp., 42 F.2d 186 (2d Cir. 1930).

2. *Treatment of the gain or loss on the exchange*

In most private annuity transactions, the fair market value of the property received by the transferee exceeds the cost of the annuity contract to him. Yet this excess has never been thought to constitute taxable income to the payor-transferee. Either the excess has been treated as a *gift,*[106] or the private annuity transaction has been treated as a *purchase* by the payor-transferee.[107] In either case, the transferee would not realize income. Where the cost of the annuity contract to the payor-transferee exceeded the fair market value of the property received, the loss on the exchange was not deductible, even though the transaction was was viewed as a sale of the annuity.[108]

3. *Treatment of the annuity payments*

The question remains whether the payor-transferee will be able to obtain any tax benefit at the time of making payments under the annuity contract. The cases suggest a number of methods for treating the payments:

(1) as capital expenditures (non-deductible, but would go to increase payor's basis);

(2) as ordinary and necessary expenses (fully deductible);

(3) as payments of combination of interest and capital (the interest would be deductible as interest; the balance would be capitalized so as to increase the payor's basis); and

(4) as payments in exchange for the property transferred (to the extent that the payments exceeded the fair market value of the property transferred, they would be deductible losses).

The vast majority of cases have required the payor-transferee to capitalize the annuity payments, thereby increasing his basis for the property received.[109] One case has allowed a deduction for payments where the annuitant was treated as a life tenant and was taxed on the

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[106]See e.g. Estate of Koert Bartman, 10 T.C. 1073 (1948), acq. 1948 P-H ¶ 76, 390; Estate of Sarah A. Bergan, 1 T.C. 543 (1943), acq. 1943-1 Cum. Bull. 2; Anna L. Raymond, 40 B.T.A. 244 (1939).

[107]See cases cited, *infra,* note 109.

[108]John C. Moore Corp., *supra,* note 105.

[109]Paul Autenreith, 41 B.T.A. 319 (1940), aff'd. sub. nom. Autenreith v. Commissioner, 115 F.2d 856 (3rd Cir. 1940) (interest on notes similar to annuities non-deductible); J. Renz Edwards, 37 B.T.A. 1334 (1938), aff'd. sub. nom. Edwards v. Commissioner, 102 F.2d 757 (10th Cir. 1939) (annuity paid by surviving partner to widow of deceased partner under partnership agreement); Robert Hoe Estate Co., Inc., 32 B.T.A. 903, aff'd. sub. nom. Hoe Estate Co., Inc., v. Commissioner, 85 F.2d 4 (2d Cir. 1936) (payment of annuity by corporation formed to take over estate); Edwin M. Klein, 31 B.T.A. 910 (1934); aff'd. sub. nom. Klein v. Commissioner, 84 F.2d 310 (7th Cir. 1936) (payment to sisters pursuant to contract made subsequent to father's death); Corbett Investment Co. v. Helvering, 75 F.2d 525 (C.A.D.C. 1935) (payment by corporation formed by residuary legatees to widow of former owner of realty); Robert L. Scott, 9 B.T.A. 955 (1927) aff'd. sub. nom. Scott v. Commissioner, 29 F.2d 472 (7th Cir.

full amount of the payments made to him.[110] Moreover, the courts have generally refused to allow the payor to deduct any part of his payments as interest,[111] despite the fact that the annuitant-transferor may be thought of as realizing interest income during the continuation of the annuity.[112] The courts have likewise refused to allow a deduction for annuity payments as losses where the amount of the payments exceed the fair market value of the property received.[113]

4. *Effect of H. R. 8300*

In the House Ways and Means Committee, an attempt was made to solve the problem of private annuities insofar as the income tax consequences to the payor-transferee were concerned.[114] Since the payor-transferee was conceptualized in the bill as a *purchaser* of property, no gain or loss was realized by him at the time of the exchange of the property for the annuity. Nevertheless, he would receive a tentative basis for the property acquired, measured by the cost of a comparable

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1928) (conveyance by father to sons in exchange for annuity); Thomas H. Mastin, 7 B.T.A. 72 (1927) aff'd. sub. nom. Mastin v. Commissioner, 28 F.2d 748 (8th Cir. 1928) (payments by trustee to beneficiaries for maintenance; Ernest & Bernice Granucci, 47 B.T.A. 662 (1942) (payments to Elliott R. Corbett, 28 B.T.A. 46 (1933), acq. VII-1 Cum. Bull. 7 (1927) (payment of annuity to widow in consideration for closing estate); Estate of T. S. Martin, 24 B.T.A. 862 (1931), acq. XI-1 Cum. Bull 4 (1932) (annuity paid to widow by corporation acquiring property from an estate); Victor J. Evans, 23 B.T.A. 156 (1931) (payment of annuities in exchange for control of business); Pacific Flush Tank Co., 17 B.T.A. 896 (1929) (payment of annuity to widow of taxpayer's president in exchange for patents); O. R. Fuller, 11 B.T.A. 1025 (1928), acq. VII-2 Cum Bull. 14 (1928) (transfer of property by father); Robert Long, 5 B.T.A. 438 (1926) (property conveyed to partnership); James H. Browning, P-H TC Memo ¶ 48,114 (1948) (payment of annuity to widow in consideration for closing estate); Herman A. and Helen S. Harper, P-H TC Memo ¶ 45,370 (1945), appeal dismissed sub. nom. Harper v. Commissioner —F.2d—, (1946), P-H ¶ 71,113 (3rd Cir. 1946) (annuity payments and maintenance expense charges on real estate); Estate of J. P. Morgan, P-H Memo TC ¶ 44,352 (1944), appeal dismissed and reversed sub. nom. Estate of Morgan v. Commissioner, (1947) P-H ¶ 71,043 (2d Cir. 1947) (annuity payments in lieu of trust fund for benefit of other persons held a purchase of part of residuary estate); Edgar W. Leonard, P-H Memo TC ¶ 44,067 (1944) (payment of annuity to obtain consent of liquidation of corporation whereby taxpayer acquired 50% of corporation's assets); A. H. Black Co., P-H Memo TC ¶ 44,006 (1944) (payments in excess of fair market value given in connection with purchase of property); S.M. 3141-A IV-2 Cum. Bull. 183 (1925); I.T. 1662, II—1 Cum. Bull. 121 (1923).

[110] Floyd M. Shoemaker, 16 B.T.A. 903 (1929). *Cf.* Citizens National Bank of Kirksville, Mo., v. Commissioner, 122 F.2d 1011 (8th Cir. 1941) (deduction disallowed for payment to life tenant who had outlived his life expectancy).

[111] F. A. Gillespie & Sons Co., P-H Memo TC ¶ 44,333 (1944). aff'd. sub. nom. Gillespie & Sons Co. v. Commissioner, 154 F.2d 913 (10th Cir. 1946) cert. denied, 329 U.S. 781 (1946); Paul Autenreith, *supra,* note 109; Edwin M. Klein, *supra,* note 109; Steinbach-Kresge Co. v. Sturgess, *supra,* note 109; Reliable Incubator & Brooder Co., 6 T.C. 919 (1946), modified, 1946 P-H ¶ 74,620; Victor J. Evans, *supra,* note 109; Robert Long, *supra,* note 109; Denman Estate Co., 2 B.T.A. 633 (1925); Jacob Hollander, P-H BTA Memo ¶ 40,332 (1940); McCrum Drug Co., Inc., P-H BTA Memo ¶ 39,987 (1939).

[112] Cases related to F. A. Gillespie & Sons Co., *supra,* note 111, in which the "interest" was taxed, are as follows: F. A. Gillespie, P-H TC Memo ¶ 44,343 (1944), aff'd. sub. nom. Gillespie v. Commissioner, 151 F.2d 903 (10th Cir. 1945); Maud Gillespie, 43 B.T.A. 399 (1942), reversed sub. nom. Gillespie, Exec. v. Commissioner, 128 F.2d 110 (9th Cir. 1942). See also Edwin M. Klein, *supra,* note 109.

[113] A. H. Black Co., *supra,* note 109.

[114] H. R. 8300, 83rd Cong., 2d sess. (1954) § 1241. § 1241 (a) provides for the income tax treatment of the annuitant-transferor, *supra,* pp. 22 et seq. § 1241 (b) provides for the income tax treatment of the payor-transferee.

commercial annuity.[115] The payor-transferee would be entitled to a deduction for interest to the extent of that portion of the annuity payment which was includible in the annuitant's gross income under § 72.[116]

In the event that the annuitant should die before reaching his life expectancy, the payor-transferee would realize "mortality gain" to the extent that the cost of a comparable annuity contract exceeded the aggregate of the annuity payments made to the annuitant, less the interest deductions allowable.[117] Such gain would go to reduce the payor-transferee's basis for the property acquired, except that no adjustment would be made so as to reduce his basis below zero. Any such adjustment not used by reason of this limitation would go to reduce other property of the payor-transferee.[118]

Conversely, if the annuitant should live beyond his life expectancy, the payor-transferee would realize "mortality loss" once the aggregate of the annuity payments, less the interest deductions allowable, began to exceed the cost of a comparable annuity contract.[119] Should the payor-transferee substitute a commercial annuity for his obligation, mortality gain or loss would occur at the time of such substitution.[120] Moreover, should he subsequently dispose of the property, a proportionate part of the mortality gain or loss would be treated as gain or loss on the sale of the property.[121]

The House bill provided a workable solution to the problem so far as the payor-transferee was concerned. He realized no gain or loss at the time of the exchange of the property for the annunity, and yet he received a tentative basis for the property acquired. He obtained an interest deduction corresponding to the amount which the annuitant included in his gross income. By means of the new concept of mortality gain and loss, the problem of the taxpayer's basis, and ultimate gain or loss, was solved. As we have seen, however, the Senate deleted Section 1241 of the House bill prior to the enactment of the new Code,[122] with the result that the income tax consequences to the payor-transferee remain the same as before the enactment of the new Code, viz:

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115 Id. § 1241 (b) (1). This section states that the value of the annuity contract shall be "as determined in subsection (a) (1)." § 1241 (a) (1) states no method for determining such value, but the House Ways and Means Committee's Report says that the "contract is to be valued by determining the amount that would be charged by a life-insurance company selling an annuity contract with similar payment terms. The value of this contract is not to be subject to a special discount for the financial condition of the particular obligor." House Rep. No. 1337, 83rd Cong., 2d sess., A286 (1954).

116Id. § 1241 (b) (2).

117Id. §§ 1241 (d) (2) (A), (D).

118Id. § 1241 (b) (4) (A).

119Id. §§ 1241 (d) (2) (B), (E).

120Id. § 1241 (d) (2) (C).

121Id. § 1241 (b) (4) (B). This, of course, would mean that such proportionate part would be capital gain or loss, assuming the property disposed of was a capital asset in the hands of the transferee.

122*Supra*, p.11.

(1) So long as the annuitant is living, the transferee's basis is the annual payment multiplied by the annuitant's life expectancy.

(2) Once the payor's obligations under the annuity contract have been fulfilled, his basis becomes the aggregate of the payments which he has made to the annuitant.

(3) The payor-transferee is entitled to no deductions at the time of payment, but the payments go to increase his basis.

(4) The payor-transferee realizes no gain on loss until he disposes of the property acquired in the private annuity transaction.

C. *Gift tax consequences to the annuitant-transferor*

The earliest attempt to impose a gift tax in the case of a private annuity was under the old gift tax law of 1924. In *Continental Illinois Bank & Trust Co., Executor,*[123] the taxpayer transferred cash and property to two charities under an agreement whereby annunities were to be paid by the charities to the taxpayer for his life, and at his death, to his widow and daughter for their lives. The Commissioner contended that to the extent that the charities gave the taxpayer's wife and daughter annunities, the taxpayer had made gifts, measured by the present worth of those annuities. The taxpayer, the Board said, has "at least indirectly made a gift [and] the gift tax is imposed upon transfers made 'directly or indirectly.' "[124]

The imposition of a gift tax on the more typical private annunity transaction, i.e. the exchange of property for an annuity did not occur until much later under our present gift tax law. Where a taxpayer transferred property to her sister in exchange for an annuity, the Tax Court held that she made a gift to the extent that the value of the property transferred exceeded the present value of the annuity.[125] The amount of the gift is determined by reducing the value of the property transferred by the value of the annuity to be paid to the transferor. Thus, where a taxpayer transferred realty in exchange for an annuity for his life, and a further annuity to his wife, should she survive him, the amount of the gift is not reduced by the value of the annuity payable to his wife.[126] Said the Court:

> The contingent annuities to Sunkea Bartman were not consideration flowing to the decedent. Their value, whatever it might be, was a value which passed irrevocably from the dominion and control of the decedent. . . . We accordingly hold that no deduction should be made on account of the con-

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[123]29 B.T.A. 945 (1934).
[124]Id. at 949.
[125]Estate of Sarah A. Bergan, 1 T.C. 543 (1943), acq. 1943-1 Cum. Bull. 2.
[126]Estate of Koert Bartman, 10 T.C. 1073 (1948), acq. 1948 P-H ¶ 76,390.

tingent annuities for the decedent's wife.[127]

Thus while the decisions with reference to the gift tax consequences of private annuities have been rather few, the cases have consistently held that the annuitant-transferor makes a gift of the fair market value of the property transferred, reduced by the present worth of the annuity payable to the annuitant-transferor. Difficulty arises as to the method of measuring this worth. While the cases involving the gift tax used Table A under the old Code,[128] the cases involving the income tax often used the cost of comparable commercial annuities[129] in determining what portion of the property transferred constituted a gift. While the new Code does not change the law with respect to the gift taxation of private annuities, in all probability, the new annuity tables issued by the Treasury for income tax purposes, will be made to accord with Table A, for purposes of determining what portion of the property should be treated as a gift.

D. *Estate tax consequences to the annuitant-transferor*

The Commissioner has sought to reach private annuities under the estate tax by several different avenues: (1) as transfers in contemplation of death,[130] (2) as transfers with retained life estates,[131] and (3) as transfers taking effect at death.[132] If the property falls within any of these three categories, then its value as of the date of death of the decedent,[133] or optional valuation date,[134] will be included in the gross estate. The fact that the transferor-annuitant receives an annuity in exchange for the transfer is not material to the inquiry with respect to the includibility of the transfer in the annuitant-transferor's gross estate,[135] since the annuity which the transferor receives in exchange is usually exhausted upon the annuitant's death.[136]

127Id. at 1078.

128Reg. 108, § 86.19 (f), Table A; 1 T.C. 543, 554; 10 T.C. 1073, 1079.

129See e.g. Anna I. Raymond, 40 B.T.A. 244, 249 aff'd. sub. nom. Raymond v. Commissioner, 114 F.2d 140 (7th Cir. 1940), cert. denied, 311 U.S. 71 (1940) (for purposes of the three percent rule, annuity promise held to be "consideration in money or money's worth." and measured by American Annuitants' Mortality Table). See also other cases cited, *supra,* notes 81, 82, and 83.

130INT. REV. CODE (1954) § 2035.

131INT. REV. CODE (1954) § 2036.

132INT. REV. CODE (1954) § 2037

133INT. REV. CODE (1954) § 2031 (a).

134INT. REV. CODE (1954) § 2032.

135Estate of Cornelia B. Schwartz, 9 T.C. 229 (1947) (value of property at death includible without any reduction for the value of the annuity); Worcester County Trust Co. v. United States, 35 F. Supp. 970 (D. Mass. 1940) (*semble*); *but cf.* Tipps v. Bass, 21 F.2d 460 (W.D.Tex. 1927) (only that portion of property necessary to produce the annuity included in decedent's gross estate).

136It is possible, of course, that the transfer may be made in exchange for a survivor or refund annuity. Such an annuity would be includible in the transferor's gross estate under § 2039 of the Internal Revenue Code of 1954, even though it might be determined that it was not includible under §§ 2035, 2036, or 2037. The latter would, of course, take precedence over § 2039, if the annuity were found to be includible as one of the taxable *inter vivos* transfers.

1. Taxation of private annuity transactions as transfers in contemplation of death.

In *Worcester County Trust Co. v. United States*,[137] *the de*cedent had a long medical history of heart ailments, swollen legs, and other difficulties. His only heirs were two nieces and a nephew. In 1927, when he had reached the age of 72, one of the nieces began to negotiate with a trust company for the establishment of a trust for the benefit of the decedent. It was agreed that the decedent would transfer substantially all of his property to the two nieces and the nephew outright, and they in turn would use this property to set up trusts, wherein the decedent would receive a life estate with a reversion in the grantors. The court held that the transfers of the property by the decedent and the establishment of the trusts were all part of a single plan which had the effect of transferring the property of the decedent to the nieces and nephews, with a life estate retained by the decedent. While this alone would not make the transfers includible in the gross estate under the law at that time,[138] it was "one of the circumstances to be taken into consideration, and in a case less clear than this, might, in connection with other circumstances, be determinative of the question whether a transfer was made in contemplation of death."[139]

The *Worcester County Trust Company Case* is not altogether in point, as the parties did not seem to be contemplating the typical private annuity transaction. A case that presents the problem more clearly is *Estate of Cornelia B. Schwartz*.[140] On June 4, 1932,[141] the decedent, at age 86, made a transfer of securities, valued at $147,366.33,[142] to her children, in exchange for their promise to pay her an annuity of $7,000 per annum. The annuity payments were to be funded by placing the securities in trust, the trustee to pay the annuity to the annuitant-transferor each year.

The medical history of the decedent indicated that, despite a number of difficulties from 1920 up until the time of the transfer, she was in good health, and finally died in 1944 at 98, as the result of a fall. On these facts, the Tax Court found that the decedent had made a transfer in contemplation of death. Moreover, since the transfer was made after March 3, 1931, the Court found that it was also includible in the de-

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[137]35 F. Supp. 970 (D.Mass. 1940).

[138]The transfer was made prior to Public Resolution No. 101 (approved March 3, 1931), when May v. Heiner, 281 U.S. 238 (1930), was the law.

[139]35 F. Supp. 970, 974.

[140]9 T.C. 229 (1947), acq. 1947-2 Cum. Bull. 4.

[141]It may be wondered to what extent decedent was moved to make the transfer as a result of the gift tax law which became effective two days after the transfer. Title III, Revenue Act of 1932 (effective June 6, 1932). Moreover, the case is not entirely typical of a private annuity transaction at arm's length, as the transferor would have to have lived to 106 to get back her investment even if it produced no income.

[142]As of the date of death of the decedent, February 13, 1944.

cedent's gross estate as a transfer in which the decedent retained a life interest.

2. *Taxation of private annuity transactions as transfers with retained life estates.*

As noted above, the Tax Court held that the transfer in *Schwartz* was one in which the decedent retained an interest in possession or enjoyment for his life, and since made after March 3, 1931, was includible in the decedent's gross estate. In the course of its opinion, the court indicated a number of factors which distinguished the instant case from the typical private annuity transaction:

(1.) The trust company, which normally filed the annuitant's income tax returns, made no attempt to report amounts paid to the taxpayer as taxable income under the annuity rules.

(2.) Payments were made by the trust rather than the payor-transferee, indicating that a trust for the life of the transferor, rather than an annuity, had been established.

(3.) Payments to the transferor did not amount to exactly $7,000 a year, but fluctuated depending upon the amount of income which the trustees received on the property transferred. This usually was slightly less than $7,000; on a few occasions, it was a little in excess of $7,000.

(4) In the estate tax return, the executor made no statement as to any claim the estate might have against the payor-transferee to the extent that some of the payments did not amount to $7,000.

Thus, *Schwartz* indicates several "don'ts" in order to avoid having a transfer in exchange for a private annuity treated as the retention of a life estate:

1. Don't fund the annuity payments by means of a trust for the benefit of the annuitant-transferor, particularly where the property transferred is used as the trust res.[143] If a trust is absolutely necessary for funding purposes, it would be more satisfactory to have the payor-transferee designated as the beneficiary of the trust, such beneficiary to have the responsibility of paying over the annuity payments each year, in accordance with the original agreement. An even more satisfactory arrangement is for the payor to fund the private annuity payments by means of a commercial annuity.

2. Don't pay the annuitant-transferor a fluctuating amount. A fixed amount, having no connection with the amount of income realized by

[143]The use of a trust in which the annuitant-transferor is the beneficiary would make the transaction look more like the retention of a life estate, resulting in the payments being taxed in full to the annuitant-transferor for income tax purposes as well as includibility in his gross estate.

the payor-transferee on the property transferred will avoid the possible contention that the annuity constitutes a life estate in the annuitant-transferor.

3. Don't make the annuity payments equal to the amount normally earned as income from the property transferred. If it is desired that the payments should equal this amount, it may be desirable to transfer only a portion of the property in exchange for the annuity, and transfer the balance by way of a gift.

3. *Taxation of private annuity transactions as transfers taking effect at death.*

In only one case [144] has it been successfully contended that the exchange of property for annuity constituted a transfer intended to take effect in possession or enjoyment at or after death. In that case, the taxpayer, aged 68, robust, and in good health, transferred realty, valued at $86,000, and personalty, valued at $431,362.53, to her three children in exchange for an annuity of $15,000 per year. On the same date, the children transferred the personalty thereby acquired to trustees as security for the annuity payments. The Commissioner included the transfers of the property in the gross estate of the decedent, and imposed an additional estate tax. In a suit for a refund, the court agreed with the taxpayer that the transfer was not in contemplation of death, but for the taxpayer's own peace of mind, and in order to spare her the care incident to the property. But, said the Court, the provision of an annuity for the taxpayer made the transfer something less than an absolute conveyance, and the transfer was therefore intended to take effect in possession or enjoyment at or after death. Accordingly, so much of the net estate as would be sufficient to produce an annuity of $15,000 for the four-year period which the decedent lived after making the transfer, was included in his gross estate.

Except for *Tips*, the courts have consistently held that the transfer of property in exchange for an annuity does not constitute a transfer intended to take effect in possession or enjoyment at or after death.[145] The rationale of this doctrine has been best stated by Judge Van Fossan of the Tax Court:

> The mere fact that the transferees of the property were obligated to pay a stipulated annuity to the transferor, the payment of which was secured by deposit of a portion of the property transferred, does not render the transfer any the less complete at the time it was made. Nor is such circumstance alone sufficient to indicate that

144Tips v. Bass, 21 F.2d 460 (W.D. Tex. 1927).

145Hirsch v. United States, 35 F.2d 982 (Ct. Cl. 1929), Lincoln v. United States, 65 Ct. Cl. 198 (1928); Security Trust & Savings Bank, Trustee, et al., 11 B.T.A. 833 (1928); Seymour Johnson, et al, Executors, 10 B.T.A. 411 (1928); Estate of Henrietta Putnam, 3 B.T.A. 823 (1926); United States Trust Co., et al, Executors, 1 B.T.A. 1086 (1926).

> the transfer of any part of the property was intended to take effect in possession or enjoyment at or after death. In this case there was no reservation by the transferor of any part of the property or the income therefrom. The transfer was absolute and complete when made.[146]

The likelihood that a private annuity transaction might be treated as a transfer intended to take effect in possession or enjoyment at or after death has been even further reduced by the fact that such a transfer has been very narrowly defined since the enactment of the Technical Changes Act in 1949. Indeed, the Internal Revenue Code of 1954 has eliminated the old language, "intended to take effect in possession or enjoyment at or after death," and has substituted "taking effect at death," which is defined equally narrowly.[147]

4. *Summary*

While it is possible that a transfer of property in exchange for an annuity may be included in the transferor's gross estate, the chances of such inclusion are very remote. It could hardly be contended today that such a transaction was a transfer taking effect at death. If the decedent lives for three years after the date of the transaction, the transfer cannot, under any circumstances, be included in his gross estate as one in contemplation of death. And, even if he should die within this three-year period, it may still be possible to show that the transfer was not in contemplation of death. Finally, *Estate of Cornelia B. Schwartz* clearly indicates how the exchange should be handled in order that it may not be included in the decedent's gross estate as a transfer with a retained life estate.

IV. Use of Annuities in Estate Planning

The Internal Revenue Code of 1954 will undoubtedly encourage the use of annuities in estate planning. Both commercial and private annuities are given favorable tax treatment, carrying forward the philosophy of the new Code of providing a greater measure of financial protection for the aged.

Commercial annuities will be more widely used because of the new annuity rules. Ordinary life annuities, refund annuities, survivor annuities—all will become popular instruments for estate planners. From the point of view of the taxpayer, perhaps the most liberal doctrine is the new provision which permits the taxpayer to recover, tax free, amounts in excess of his cost, if he outlives his life expectancy. In the case of refund annuities, amounts received by the annuitant's beneficiaries after his death will normally be free of tax.[148] Husband and wife

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[146]Seymour Johnson, et al., Executors, 10 B.T.A. 411, 415 (1928).
[147]Int. Rev. Code (1954) § 2037.
[148]*Supra,* note 15; *but see supra,* note 37.

will find survivor annuities useful, in planning for their retirement. Or, a man of property may find it advantageous to provide his son and daughter-in-law with a survivor annuity, as a method of settling an estate upon them. The use of the commercial annuity in estate planning is limited, however, by the requirement that liquid assets must be available in order to finance the purchase of such annuities. To some extent, this can be overcome by the purchase of a retirement annuity over a period of years. In many situations, however, it may be more desirable to use a private annuity.

The private annuity is a particularly useful device in estate planning. No income tax is imposed on the exchange of the property transferred for the annuity to either the annuitant-transferor or the payor-transferee. Moreover, the annuity payments are taxable under the liberal annuity rules of the new Code. To the extent that the value of the property transferred exceeds the cost of a comparable annuity contract, the annuitant-transferor makes a taxable gift, but proper use of the transferor's gift tax exemption and exclusions will minimize the effects of the gift tax. Finally, the annuitant-transferor will be able to dispose of his non-liquid assets without his estate being depreciated by an estate tax. Wholly apart from its tax consequences, the private annuity has the additional advantage of relieving the annuitant-transferor of management repsonsibilities at an age when he will no doubt be anxious to enjoy his retirement.

The advantages of the private annuity can be illustrated by the following example:

Assume that Mr. Green owns a farm for which he paid $100,000, but which is now worth $250,000. At the time of the purchase of the property, he and his wife took the title as tenants by the entirety. This is Mr. Green's only substantial asset. The farm is free of any mortgage. It produces a net income of $12,000 per year. Both Mr. and Mrs. Green are aged 65. Mr. Green has a ten-year life expectancy and Mrs. Green has a fifteen-year life expectancy. They have one son, John, aged 33. Mrs. Green assets are nominal. Both Mr. and Mrs. Green have executed wills. Mr. Green's will provides that his property shall go to Mrs. Green, if she survive him, and to his son, John, should she predecease him. Similarly, Mrs. Green's will provides that her property shall go to Mr. Green, if he should survive her, and to her son, John, should Mr. Green predecease her.

If we assume that Mr. and Mrs. Green live to their life expectancies and no longer, and that they do nothing about their property, they will have to pay a Federal income tax of $1,596 and a Mississippi income tax a $100 per year for the next ten years. For the two years immediately following the death of Mr. Green, the new Code permits Mrs. Green

to continue to split her income,[149] so that it will continue to be taxed at the rate of $1,596 a year. The Mississippi income tax for this period, however, will now be $175. After two years following the death of Mr. Green, the Federal tax will increase to $2,332 a year, and the Mississippi income tax will continue to be $175. Accordingly, the total income tax liability for the Greens for the rest of their lives will be as follows:
For the next ten years:

Federal	($1,596 x 10)	$15,960	
Mississippi	($100 x 10)	1,000	$16,960
For two years after the death of Mr. Green:			
Federal	($1,596 x 2)	$ 3,192	
Mississippi	($175 x 2)	350	3,542
Subsequent three years:			
Federal	($2,332 x 3)	$ 6,996	
Mississippi	($175 x 3)	525	7,521
Total			$28,023

If Mr. Green should predecease Mrs. Green, his estate will suffer a shrinkage at death in the amount of $18,500, if we assume that the cost of administration of the estate is approximately $5,000. This shrinkage is calculated as follows:

Gross estate		$250,000
Less: Administration expenses	$ 5,000	
Marital deduction	122,500	
Personal exemption	60,000	187,500
Taxable estate		$ 62,500
Federal Estate Tax (including credit for State death tax)		$ 10,020
Mississippi death tax:		
Gross estate	$250,000	
Less exemption and administration expenses	55,000	
Taxable estate	$195,000	
Mississippi Death Tax		$ 3,480
Administration expenses		5,000
		$18,500

At Mrs. Green's death, the value of the estate will be further decreased

[149] INT. REV. CODE (1954) § 2.

as a result of additional death taxes and administration expenses:

Gross estate ($250,000 minus $18,500)			$231,500
Less Administration expenses and personal exemption			65,000
Taxable estate			$166,500
Federal Estate Tax:			
Tentative tax		$40,650	
Less credits:			
State death tax	$ 636		
Prior transfers[150]	6,012	6,648	$ 34,002
Mississippi Death tax:			
Gross estate	$231,500		
Less exemption and admin. exp.	55,000		
Taxable estate		$176,500	
Mississippi Death Tax			3,036
Administration expenses			5,000
Total shrinkage			$ 42,038

Thus, in order for the Greens to transfer the farm to John, the value of the property will have to be decreased by a total estate shrinkage of ($18,500 plus $42,038). This makes no allowance for additional shrinkage as a result of a forced sale of a portion of the property in order to obtain liquid assets for the payment of death taxes and administration expenses.

Should Mrs. Green predecease Mr. Green, no estate tax would be due at her death, but upon the death of Mr. Green, there would be the following death taxes and administration expenses:

Federal Estate Tax	$43,920
Mississippi Death Tax	2,280
Administration expenses	5,000
Total shrinkage	$51,200

To some extent, the death tax burden of the Greens could be reduced by the conventional estate planning solution of converting their tenancy by the entirety to a tenancy in common. This would eliminate most of the death tax upon the death of the first decedent, but would be of no help to the Greens upon the death of the second decedent. Another solution would be for the Greens to make a present gift of the farm to John, but this would involve the payment of a gift tax, and the

[150] INT. REV. CODE (1954) § 2013.

Greens would no longer have any income-producing property.

On the other hand, an exchange of the farm for a private annuity will provide an estate planning solution that will be advantageous tax-wise and still solve their estate planning problems.

Assuming that it would cost the Greens approximately $150,000 to purchase a comparable commercial survivor annuity, they should transfer three-fifths ($150,000/$250,000) of their farm to John in exchange for his promise to pay them $12,000 a year for their joint lives and the life of the survivor. The balance of the farm should be transferred to John by way of inter vivos gift.

If such a transfer is made, the tax consequences to the Greens will be as follows:

1. *Income taxes.* There will be no tax upon the exchange of the farm for the annuity. The payments will be taxed under § 72 of the 1954 Code, so that $10,000 ($150,000 / 15 years, the life expectancy of the survivor) would be excluded annually from gross income. As a result, only $2,000 a year would be taxable to the Greens for their joint lives and for the life of the survivor. Since this would be less than their total personal exemptions and the retirement income credit[151] of the new Code, they pay no income tax for the rest of their lives. The Mississippi income tax consequences are so negligible that they can be ignored. [152]

2. *Death taxes.* The Greens will have no death taxes to pay, since they have disposed of all their estate. Having exchanged their major asset for a private annuity, the assets in both of their estates will remain nominal. While the value of the survivor's right to the annuity will be included in the gross estate of the first decedent, such an amount will be well under the $60,000 exemption.

3. *Gift taxes.* Assuming that neither of the Greens have used any portion of their gift tax exemptions, they will have to pay a Federal gift tax in the amount of $2,790,[153] on the transfer of two-fifths of the farm to John as a gift. Since the remaining three-fifths of the farm was transferred for an adequate and full consideration in money's worth, there would be no gift tax as to this portion.[154]

Since John, the pavor-transferee, is treated as making a *purchase* for

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[151]INT. REV. CODE (1954) § 37.

[152]The Mississippi Code makes no special provision for the income taxation of annuities. In the absence of any such provision, payments would be taxed to the Greens only after they had fully recovered their cost. At the earliest, this would be five years after the commencement of the annuity payments. Even then, the most the Greens would have to pay in Mississippi income tax would be $175 per year.

[153]This is the *only* tax liability that arises out of this particular private annuity transaction.

[154]Mississippi has no gift tax.

income tax purposes, he realizes no income with respect to the private annuity transaction until he subsequently disposes of the farm in an arm's length transaction. Moreover, he obtains a basis which would normally be higher than what it would be if he had acquired the property by way of an *inter vivos* gift. His basis for the farm will be calculated as follows:

As to that portion acquired by gift (2/5 of $100,000)	$ 40,000
As to that portion acquired by exchange for a private annuity (discounted value of the annuity payments due the Greens)	150,000
	$190,000

Since his income from the farm will approximately equal the annual payments, he may find it advisable to fund part, or all, of his annuity obligation by means of a commercial annuity,[155] payable to himself for the joint lives and the life of the survivor of his mother and father. The liquid assets necessary to purchase such an annuity can be obtained by John's mortgaging the farm. After the death of his father and mother, John will have no difficulty paying off the mortgage out of the income from the farm.

From the above, it will be noted that the effects of the use of the private annuity in the estate planning of the Greens is to save them approximately $75,000 in taxes during their later years.[156] Moreover, both Mr. and Mrs. Green are relieved of the responsibilities of management, and will be able to enjoy their retirement. At the same time, they will have disposed of their property to their only son, the natural object of their bounty.

Variations on the above plan can be devised to meet differing situations. Thus, the private annuity may be found to be particularly useful to the childless couple who are planning to leave their property to

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[155]This procedure should be used wherever there is some question as to the financial responsibility of the payor-transferee.

[156]Total tax savings may be calculated as follows:

Income tax savings		$28,023
Death taxes at Mr. Green's death:		
Federal	$10,020	
Mississippi	3,480	$13,500
Death taxes at Mrs. Green's death:		
Federal	$34,002	
Mississippi	3,036	37,038
Total		$78,561
Less: Gift tax on private annuity transaction		2,790
Net tax savings		$75,771

a charity. A consultation with the charity's officials may indicate that the charity is anxious to acquire the particular property of the couple, and would be happy to pay them an annuity as an easy method of payment. Such a plan would relieve the couple of all tax problems, give the charity the present use of the property, and assure the couple of a steady tax-free income for the rest of their lives.

V. Conclusion

Because of the favorable tax treatment provided annuities under the Internal Revenue Code of 1954, their use will become more widespread. Both commercial and private annuities should prove to be useful tools in the field of estate planning.

It is unfortunate that the Senate Finance Committee eliminated the private annuity section of the House bill. As a result, the estate planner who seeks to use the private annuity must work with a very confused body of law. Congress will eventually act with respect to this important area of taxation, but since tax statutes are normally not retroactive, until that time, the private annuity offers not only tax advantages to the taxpayer, but a solution to many estate planning problems.

ECONOMIC ASPECTS OF INVENTIONS AND LEGAL MONOPOLIES†

Harry A. Mitman*

A study of history shows that practically all of the greatest growth in invention has occurred within the last two centuries, and most of the variety of mechanical, chemical and electrical products and the great expansion of human comforts resulting therefrom, has taken place within the past half century.

Does this mean that invention as an art suddenly sprang up into existence two hundred years ago? Of course the obvious answer is no. Man has always been inventive. What is new in the past several hundred years is the development of a patent system which has helped to bring technical invention into the life of the common man and made available to him the devices he needed to remove him from slavery and to enrich his life. Because of the development of a patent system, our Western civilization has become dominant. This great legal development was truly a forward step for our Western civilization, and the culmination of its development is the United States Patent System. The United States Patent System is one of the basic supports of our American economy and it has done more toward the expansion and development of our resources and industry than any other thing.

The Inventor Has Always Existed

Man, the inventor, has always existed. Because he might upset the existing privileges of dominant minority groups, our first civilizations forbade him to exercise his skill to produce mechanical devices except for the art of war and then under the strict supervision of the state, church, or guilds. The powerful Roman state of the early Christian Era was an excellent example of this type of civilization and its prohibitions against the mechanical inventors resulted in throwing away the one group of persons which might have saved the Roman state in the time of its peril. In the year 397 A.D. a decree was issued in Rome which even forbade introduction of such lowly things as trousers, then regarded as a barbaric invention, and also in the year 416 A.D. fur garments were forbidden by a similar decree. Other decrees against new things and inventions were common under the Roman Empire.

Later, an improved type of civilization, the Saracen Empire, permitted the inventor to exist but did not have a method of insuring a steady perpetual flow of new mechanical devices into the common man's

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*Member Mississippi and District of Columbia Bar; United States and Canadian Patent Bar; Registered Professional Engineer, State of Mississippi; Patent Counsel, Masonite Corporation, Laurel, Mississippi.

daily life. Under this state, which flourished from the Sixth to the Fifteenth Century, great progress was made in technology as compared to the earlier civilizations. Comparison of the American and the Saracen civilizations shows many similarities, as for example, scientific and mercantile achievements and, what is more important, individual freedom. This feature of individual freedom is stated to be the reason for the greatness of both nations. Although the Saracen Empire with its freedom to use invention was a great advance over the Roman Empire with its prohibition of invention, yet it lacked the one essential preservative of a civilization, namely, a method of insuring a perpetual steady flow of inventions. It was this lack that has caused the break-down of the great empires of the past, for it is only by perpetual flow of inventions into daily use that a people in a widespread nation can keep in close daily contact, and by which bonds of economic and military defense may be forged.

For example, it is often stated that steam railroads, alone, made the United States possible. Others have pointed out that had the Roman Empire had a system of steam railroads, it could have survived the onslaughts of the barbarians. Why did not the Roman Empire have steam railroads? Iron, concrete, wood and bronze were available. Wheels, bridges and many other inventions and needed skills were available. Hero of Alexandria had a steam turbine in operation. Hero could by law, however, use the steam turbine only for purposes approved by his guild, the priesthood. So the power to save Rome was restricted by superior planners. They had all the materials available to build railroads if the inventive creativeness of the people had not been restricted. Missing was that great flow of invention needed to produce the essential components of a railroad, to adapt it to all the varied uses even then needed to make a railroad a success, and to induce the thousand other enterprises based on invention needed for improvement and further adaptation.

Through the centuries many of the fundamentals of our present day basic inventions were known prior to the time of the past two centuries. Prior to the Tenth century, glass making, pottery making, power machines, water mills, lathes, and other machines were known in somewhat crude form, and mathematics, physics, and other sciences were known. In the Tenth to the Fifteenth centuries inventions such as saw mills, wire pulling machines, paper mills, compound lenses, magnetic compasses, spinning wheels and many more were developed. From the Fifteenth century we have authenticated manuscripts of Leonardo da Vinci showing disclosures of machines such as centrifugal pumps, breech loading cannons, anti-friction rolling bearings, conical screws, hydraulic presses, bevel gears, spiral gears, compasses, printing presses, parachutes, a submarine boat and many more. All of these things were known; yet they were not developed to any degree.

Inventions Stimulated by Incentive

Why is it, that over these past centuries, so many of these useful inventions did not progress beyond very minor stages of development and the uses thereof were limited? The fact that there was no incentive given to the individual in the form of some kind of legal protection retarded development of these basic inventions in the past centuries. On the whole, invention results from ambition on the part of the individual to make secure his own position in our economy by unswerving devotion to creative and productive activities. Any influence that minimizes incentive and inducement to an inventor and thereby restrains the ambition of an inventor retards our industrial development, thus strengthening our enemies as we deprive ourselves of strength. If the individual incentive is furnished to the individual, as has been done under our Constitution,[1] then strengthening of an economy will follow.

It is sometimes argued that patents on inventions are not really much of an inducement or an incentive anyway and that inventing is mostly automatic and inevitable, and further that war or other necessities supply the inducement needed. Of course, there is no way to prove such a statement. The most that can be done is to show that a particular invention here or there came without benefit of patents, but such inventing through centuries of recorded history did little for the useful arts and left the standard of living scraping bottom. What we are interested in is the reason for the floodtide of inventions that we have had in the past one hundred years, and especially during the past fifty years or so, which really have done something for Man's standard of living. As to this, the evidence is all against the suggestion that inventions will come as well without patents.

It is no accident that all the countries of the world with advanced technologies have patent systems, and it is particularly significant that the country which outstrips them all, the United States, has the best patent system.

For a brief moment, compare the nations of the world that have relatively weak patent systems to the United States with its strong system and you will then see the nations which are quite inferior in technological advancement as compared to the United States and, at the same time, in such countries you will find a relatively weaker industrial structure and economy. Prior to the World Wars, Germany had a strong patent system. Germany was then one of the world's most powerful nations industrially, and this helped tremendously in developing a powerful internal economy. France, on the other hand, has a relatively weak patent system, and France is relatively weak industrially and in its internal economy. China seemingly has unlimited human and natural re-

[1]Article I, Section 8 of United States Constitution.

sources but with no incentive given to its people to develop new products and the resources, the nation has not advanced in its industrial development and it has a weak internal economy. Apply this test to other nations of the world and you will find that the pattern follows through.

Basis of the American Patent System

When the authors of our Constitution wrote Article I, Section 8 into the document, no doubt many of the people were surprised. In general, they were monopoly haters since they had suffered under the monopolies granted by the British Crown on goods they bought and the imposition of these monopolies led on to the Revolutionary War. So, in fact, they were monoply haters and yet, under Article I, Section 8 of the Constitution, they granted a limited monopoly to inventors. Since that time, in more recent years, our Congress has passed laws which make monopolies illegal under the Sherman and Clayton Anti-Trust Laws, but the monopoly granted to inventors under our Constitution still stands. Article I, Section 8 of the Constitution reads as follows:

> "The Congress shall have power to promote the progress of science and useful arts by securing for limited times to authors and inventors an exclusive right to their respective writings and discovies."

Congress in 1790 at its very first session exercised this constitutional power by passing a law arranging for the grant of a patent to any inventor of a new and useful invention upon petition to the Secretary of War and the Attorney General. The first known patent under the new law was for a method of making potash, the grant was signed by George Washington, President of the United States, and was issued to a man by the name of Samuel Hopkins.

Patent Grants - The Stimulant Behind Industry

While we have been considering only the just claims of the inventor to material recognition for the benefits which society gains from the invention, attention will now be called to the remarkable results which flow from this recognition of the inventor's claim to a share of the benefits granted under the Constitution and patent laws.

While the constitutional provision speaks of promoting the progress of science and useful arts, it did not until later become generally realized that this recognition of a property right in an invention was a major stroke of statecraft. Instead of being merely a recognition of the rights of inventors to a reward for their inventions, it turned out to be a powerful stimulant to the production of new ideas and the creator of industries. Further, it not only gave just recognition to inventions which were

produced but it actually served to create new ones since expanding industries created new demands and stimulus for improvements on the existing inventions.

Since that time, history has shown that this patent monopoly on inventions granted under the Constitution and the patent laws passed by the first Continental Congress, has made our nation grow in scientific and industrial achievements unsurpassed in the history of the world and all this has occurred within a period of less than two centuries. These dynamic achievements are one of the basic foundations of our economy. All this came about fundamentally through so simple a device as a legal recognition of an obligation to the inventor, the man who is at the root of progress of our industrial economy. It must be remembered that invention can arrive only through the processes of the human mind and if the reward is applied at the very point of emergence of the idea from the unknown, it supplies the needed incentive to create that which otherwise would be lacking.

Benefits Flowing from the Patent Grant

Consider a few things that the limited monopoly grant does for an inventor and an industry in receiving the patent grant:

First, the granting of the patent automatically matches the size of the reward to the size of the inventor's contribution to the public good as nearly as is humanly possible. If the invention is of great value, the public will be ready to pay the inventor well for the use of the invention during the term of the patent. If it is of small value to the public, the inventor can collect only a small amount for its use or sale. Further, it requires none of the taxpayers' money to provide the reward for the inventor. In fact, even the administrative costs in obtaining the patent have, in general, been covered by fees paid to the government by the inventor.

Second, an exclusive right granted on an invention serves to put on the market new inventions which otherwise would be left to die. Putting a new thing on the market requires much research in the form of experimenting, engineering, designing, trials and redesigning to get it into the shape which is acceptable to buyers and economical to make, and, in most cases, a lot of sales promotion. This stage of promoting and marketing the results of an invention is what Charles Kettering calls the "shirt losing" stage because it costs so much while there are no returns. No one is likely to go to all this trouble and expense and take the chances involved unless he has assurance that others cannot copy his product, when it is finally in shape, and so with no preliminary expense undersell him in the market. The exclusive right granted under the patent gives that assurance of protection for a limited time and will induce fi-

nancial and industrial interests to put their resources behind an invention for development on a commercial scale.

Third, even though this may sound contradictory, the patent's exclusive grant induces the most beneficial kind of competition, namely, the competition which makes improvements in the useful arts and which results in a further expansion of our industry and our economy. If there were no exclusive grant, each business rival would immediately copy improvements made by any one of the others so that soon none of them would go to the trouble and expense of making improvements at all. With the exclusive right, one rival improves his product by an invention and each of the others, knowing he cannot copy that improvement without subjecting himself to litigation and damage claims, must hustle around to find some other improvements as good or better so that he can stay in business. That is the kind of competition that has put us ahead in the world in the useful arts and made our economy dominant.

Fourth, aside from the competition, the exclusive right granted under the patent is a strong incentive to business enterprise because the only way the patent owner or the licensee of the patent owner can collect the reward for the contribution to the useful arts is to make and sell the product of the improvement while his exclusive right lasts. Through this the economy is expanded and strengthened.

Patents Protect Individuals and Help to Build New Industry

Perhaps the benefits to the inventor of the legal monopoly granted under a patent can best be illustrated by a concrete example. One of the most interesting examples out of the thousands that could be given concerns a cobbler by name of John Tufford. In doing repair work on many pairs of shoes over a period of years he noted that the flat rubber heels in use at that time tended to pull away from the supporting surface to form slight openings at the edges. Grit and dirt tended to work into the openings between the rubber heel and the heel supporting surface. Tufford reasoned that if the heel were made slightly concave on the innerside and slightly convex on the outer side, when nails were driven into the heel to fasten it onto the shoe, the edge would be sealed tightly around the periphery of the heel. He then experimented with his idea and found it sound.

He showed this new type heel to some friends of his who worked as salesmen in a nearby shoe store and they became quite enthusiastic over the new product and urged him to take out a patent on his idea. Tufford had no money to finance the project, so he and his shoe salesmen friends pooled their resources and applied for a patent, which was granted.

Tufford and his associates then worked out an arrangement with a

rubber manufacturer to manufacture heels for them in accordance with the patent. The new type heel was an almost instant success, and Tufford subsequently built his own factory. In the meantime, other rubber manufacturers, who made the old type or flat rubber heels, began to infringe on the Tufford patent. Over a period of years Tufford brought suit against many infringers and obtained injunctions and damages in those cases where the courts found that infringement of the patent existed.[2] The Tufford patent and the developments therefrom were the base or the beginning of the modern rubber heel industry in this country, and during its life made wealthy men of Tufford and his associates.

This story merely illustrates the benefits that accrue to an inventor and also shows the development of a new industry as a result of patents. The fact that the inventor had the protection of the patent laws enabled him and his associates to proceed in the development of his product, and this, of course, developed into an industry employing thousands of people.

Patents Protect Industry and Help to Create Jobs

Another example which illustrates the development of a large industry from a patent on an idea relates to Masonite Corporation. This story took place over the last thirty years. When William Mason first made a small sample of hardboard from exploded wood fiber during the middle 1920's at Laurel, Mississippi, no one dreamed that his experiment would be the basis for the present day modern hardboard industry now spread throughout the world. When Mason obtained his first hardboard patent, a group of men who had faith in the idea were willing to back the idea with their resources because of the existence of patents on the product. This group of men poured their money and energy into the project to back the idea and built a small plant at Laurel. As sales for the new type product increased, productive capacity of the plant was also increased.

Later on, a well-known corporation which engaged in manufacturing building products began to infringe the patents by making a hardboard product. Masonite Corporation at that time was a relatively small company and in bringing suit against a wealthy and well established corporation, the financial resources of the Masonite Company were terribly strained. However, suit was brought in the District Court of the State of Delaware. After extended litigation, the Court of Appeals in

[2]In the case of F. & S. Leather Co. v. I.T.S. Rubber Co., 260 Fed. 939 (6th Cir. 1919), the phenomenal development of the patented rubber heel is discussed, and the opinion of District Judge Westenhaver is referred to in some detail. The Court pointed out that without advertising or soliciting salesmen, the business grew from a production of a few thousand heels a month to over two and one-half millions in about three years time, and with an initial capital of $30,000 at the start of the operation, the undivided profits in three years time had grown to $800,000. Later, through advertising and salesmanship, the business expanded much more.

Philadelphia held that the patent in suit was valid, and that the operations of the defendant infringed the patent.[3]

If the courts had not sustained the patent and thus protected the inventor and his associates, Masonite Corporation would probably not be in existence today. Since that time, Masonite Corporation has expanded its hardboard products in many countries throughout the world. Today the hardboard industry in this country produces almost two billion square feet of hardboard each year and gives employment to many thousands of men and women.

Laws Protect Against Willful Infringers

Here again is an illustration of the development of an idea into a product to serve mankind. The patent laws were available to protect the idea against infringers and, as a result of this, a new industry was born in this country which expanded throughout the world. Certainly, if the limited monopoly granted under a patent had not been available to protect the inventor and the investors behind the idea, mankind might today not have the benefit of hardboard and its attendant benefits. Certainly none of the original investors in Mason's idea would have gone into the venture and risked their capital without patent protection on the invention. Even though the invention seemed good, in the absence of patent protection, investing in such a venture would have been too hazardous.

Benefits of Patents Apparent in All Phases of our Economy

These stories could be multiplied by thousands of similar illustrations. Almost everything which we wear, processed food which we eat, means of communication, means of entertainment, means of transportation, building materials, in fact, practically all material things which are available to us, are founded on research, invention and patents. There are very few exceptions. Developments similar to those in the field of the steam turbine or steam engine, the hardboard field, and the rubber heel industry have happened in many other fields and the patented improvements over the basic ideas in each of these fields have constantly kept our economy expanding and growing. As a further illustration to show industrial growth through development of basic ideas through patentable improvements, we can take a look at the candle and note that the candle gave way to the gas jet, the gas jet to the carbon arc light, the arc light to the incandescent bulb and the incandescent bulb is now giving way to the vapor lamps or the fluorescent types. What the future improvements will be with respect to lighting, no one can say, but one

[3]Masonite Corporation v. Celotex Corporation, 66 F.2d 451 (3rd Cir. 1933). The defendant filed a writ of certiorari in the United States Supreme Court, 316 U.S. 267 (1941), but before the petition was acted upon, an agreement between Masonite and Celotex had been completed, and the petition was dismissed.

can safely say that further changes and improvements will be made in the years to come.

All of us can remember familiar things in years gone by that now we scarcely see, in fact, in many cases, we no longer see. More important still, these changes caused primarily through patentable improvements on existing things, which many of us have witnessed over the past years, have affected entire callings and business operations and have either obliterated them or changed them, so that they bear little or no resemblance to their original forms, and new trades and callings arise with these shifts in our industrial economy.

According to recent estimates of the National Association of Manufacturers, seventy-five percent of the jobs in this country are due to inventions made within the last fifty years. In other words, the greater portion of jobs in this country are in work which was non-existent fifty years ago. It is thus vitally important, in order to promote further industrial progress and a sound economy in the future, to stimulate the inventive mind through inducements which are a compelling force behind individual incentive.

During the early years of this century, wagon manufacturing was a flourishing and prosperous industry in this country. As the automobile industry gradually developed, many wagon manufacturers could not be impressed with this new invention, the automobile, and they refused to change their business routine. The early developers of automobiles were faced with difficulty in persuading many wagon manufacturers to build automobile bodies because it meant change from the normal routine in wagon production. A few wagon manufacturers, however, cooperated in the development and, as the transition from wagons to automobiles gradually took place, these few manufacturers were ready for the change and they became the well known automobile body manufacturers of today. The wagon manufacturers who refused to recognize the changing trend of the times gradually passed from the manufacturing picture, and today very few wagon manufacturers of any substantial size are still in operation. Failure to recognize changing conditions may often lead to economic ruin, while on the other hand, ability and willingness to recognize progress and changes in our economy will, if handled properly, be the salvation of a downhill business.

The Patent System Has Survived Attack

Notwithstanding the positive benefits which have flowed from the American Patent System, it has been under attack on numerous occasions in the past century and a half. While under attack, theorists would try to show that inventions would continue to flow from the minds of inventors even though no incentive in the form of patent protection were

granted. So far, more experienced and practical minds have been able to stem the attack.

Many years ago, Thomas Jefferson said, "The issue of patents for new discoveries has given a spring to invention beyond my conception." But at that time, Jefferson had not yet even begun to witness the miracles of invention brought about in later years through the incentive of patents. Abraham Lincoln said, "The patent system added the fuel of interest to the fire of genius." In an editorial appearing in the New York Times as far back as May 8, 1908, the editor stated as follows: "Yankee ingenuity became a by-word the world over because of patent laws of unprecedented liberality."

A more recent expression of understanding of the benefits of the Patent System is shown by Dr. James B. Conant, former President of Harvard University, in the following words:

> "Basically, of course, a patent is a highly restricted monopoly granted to an inventor for a period of years. Without the protection afforded by such a monopoly many an invention would have remained a paper scheme; the capital requisite for turning the invention into a reality would hardly have been forthcoming without governmental protection for both the inventor and the innovator (to use Maclaurin's phrase for the business man who gambles on a new invention)."[4]

It is also interesting to note the views of The New England Council, which has a membership of about two thousand representing small and medium sized businesses and industry of New England. In a memorandum submitted to a congressional committee in speaking of the patent grant, they said as follows:

> "We know its power as an incentive to enterprise as a matter of both historical and present day fact.
>
> "The benefits to the public . . . are very largely proportional to the potency of the patent as a protective instrument effective through its power of exclusion or through the alternative values obtained when admittance to the protected area is permitted at a price. The potency of the patent as such an instrument involves (1) the nature and the extent of the profit-making values which attach to it in the form of the rights or privileges given to the patent owner, and enforced by the courts and (2) the degree of certainty one may have that a patent will be effective to give its owner those values, since its efficacy as an inducement is lessened whenever assurance of realization of that prospect becomes questionable."

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[4]Science and Common Sense, Yale University Press, 1951.

During the 1930's and early 1940's, under the administration of the late President Franklin D. Roosevelt, the Patent System was again under severe attack by some of the New Deal theorists. In 1941 President Roosevelt issued an executive order establishing a commission known as the National Patent Planning Commission to study and report on the American Patent System and its operation.[5] The report of this Commission included the following conclusions:

> "The American patent system established by the Constitution giving Congress the 'power to promote the progress of science and useful arts,' is over 150 years old. The system has accomplished all that the framers of the Constitution intended. It is the only provision of the government for the promotion of invention and discovery and is the basis upon which our entire industrial civilization rests.
>
> "The American people and their government should recognize the fundamental rightness and fairness of protecting the creations of its inventors by the patent grant. The basic principles of the present system should be preserved. The system has contributed to the growth and greatness of our nation; it has:
>
> (1) encouraged and rewarded inventiveness and creativeness, producing new products and processes which have placed the United States far ahead of other countries in the field of scientific and technological endeavor;
>
> (2) stimulated American inventors to originate a major portion of the important industrial and basic inventions of the past 150 years;
>
> (3) facilitated the rapid development and general application of new discoveries in the United States to an extent exceeding that of any other country;
>
> (4) contributed to the achievement of the highest standard of living that any nation has ever enjoyed;
>
> (5) stimulated creation and development of products and processes necessary to arm the nation and to wage successful war;
>
> (6) contributed to the improvement of the public health and public safety; and

[5]The Commission comprised Dr. Charles F. Kettering, Chairman of the National Inventors' Council and Vice-President of General Motors Corporation in charge of its Research Laboratories; Chester C. Davis, Member of the Board of Governors of the Federal Reserve System; Francis P. Gaines, President of Washington and Lee University; Edward F. McGrady, formerly First Assistant Secretary of Labor, then in charge of Labor Relations for Radio Corporation of America; Owen D. Young, Honorary Chairman of the Board of the General Electric Company and Member of the Board of Directors of Radio Corporation of America, the National Broadcasting Company, and the Federal Reserve Bank of New York City; Andrey A. Potter, Executive Director; and Conway P. Coe, then Commissioner of Patents, Executive Secretary.

(7) operated to protect the individual and small business concerns during the formative period of a new enterprise."

At the present time, the patent system is not under direct attack from either the executive or the legislative branches of our naional government, but some of the "New Deal change" ideas still seem to be strongly rooted in the judicial branch of our government and some courts, including the United States Supreme Court, appear to go to extremes in holding patents invalid.[6]

The Future Outlook for New Developments is Good

Having discussed the tremendous industrial expansion and development in this country and the part the Patent System plays therein, it is fitting to give some thought on what the future may hold for us in that part of our economy. The question naturally arises—Can this progress go on indefinitely? In the last fifty or sixty years, we, in this country, have developed, primarily through invention, the greatest industrial machine the world has ever seen. It is of tremendous size, complicated and

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[6]Jurgersen v. Ostby & Barton Co. (1949) 335 U.S. 560. In writing the dissenting opinion, Mr. Justice Jackson appears to reveal the rather strongly rooted ideas existing within the Court directed toward striking down patents, where he said:

"It would not be difficult to cite many instances of patents that have been granted, improperly I think, and without adequate tests of invention by the Patent Office. But I doubt that the remedy for such Patent Office passion for granting patents is an equally strong passion in this Court for striking them down so that the only patent that is valid is one which this Court has not been able to get its hands on."

Two years later in the Great Atlantic & Pacific Tea Co. vs. Supermarket Equipment Co., 71 Sup. Ct. 127, Mr. Justice Jackson appeared to have fallen in line with the majority thinking of the Court when he wrote the majority opinion in striking down the patent involved. In fact there was no good excuse in this case for the Court to accept jurisdiction in the first place. The two lower courts had sustained the patent, and the Supreme Court apparently took jurisdiction because it believed that the two lower courts had been too lenient on the question of the amount of novelty required.

In this case Justices Douglas and Black wrote a concurring opinion in which they state:

"The invention to justify a patent had to serve the ends of science—to push back the frontiers of chemistry, physics, and the like; to make a distinctive contribution to scientific knowledge."

The opinion also says that the question of amount of novelty must be referred to "a standard written into the Constitution." The opinion does not, however, point out the words that are supposed to establish the standard. From the constant repetition of the term "science" throughout the opinion, one may infer that Justices Douglas and Black actually feel that the Constitution authorizes patents only for the discoveries which "push back the frontiers of chemistry, physics and the like." The Justices appeared to entirely overlook the phrase "useful arts" in Article I, Section 8 of the Constitution. It is unfortunate in writing the opinion that some of the objective invention standards of the lower courts were ignored, and the Supreme Court should attempt to set up such a severe test which certainly appears to depart from the liberal patent policy written in the Constitution. Further discussion on "Are the Courts Carrying out Constitutional Public Policy on Patents" may be found in Journal of the Patent Office Society, Volume 34, pages 766-791 (1952)

During 1952 Congress acted on a revision and codification of the laws relating to patents and the Patent Office, and enacted into law title 35 of the United States Code entitled "Patents" which became effective January 1, 1953. The new Act contains provisions which are intended to codify the common law of patents as to some points on which courts have been departing from well established and time tested doctrines. No cases of importance relating to patents covering the quesitoned doctrines have been decided by the Supreme Court since the Act became effective.

difficult to understand economically and it moves forward with terrific speed. The developments in atomic energy are only a surface indication of a current, deep and swift, which is carrying us somewhere, but we are not sure where. We may well ask ourselves the question—Can we go on like this forever or where is the tapering off point?

We are not at a tapering off point and if continued incentive through limited monopoly in the form of patents is given to inventors, then research, inventions and expansion of our industrial economy will continue to grow to such a degree that our present day manner of living will be outmoded within the next decade or two.

The principal reason for this optimistic assertion concerning new inventions, developments, and the expansion of our economy is the enormous increase of industrial research, the extent of which is not generally known. It is well known that research has been expanding at an extraordinary rate but few people are aware of how astonishing that growth has been. Actually the expenditures for organized research in industry in the last eight years beginning with 1946 have been more than twice as large as the total for all previous years up to 1946. In all the years prior to 1946, industry spent slightly more than four and one-half billion dollars on research, but in the last eight years industry has spent nine and one-half billion dollars on research. Industry is willing to risk such research expenditures because it knows that any new inventions, which might be developed, will be given the benefit of patent protection for a limited period of time. This tremendous expenditure by industry for research is further supplemented by expenditures of the government on research of nearly eleven billion dollars since the beginning of 1946. This, too, is more than twice as large as all research outlays by the government before 1946.

Research Precedes New Products on Market by Several Years

Experience in industry over a period of years has demonstrated that new inventions developed from research seldom reach the market before six to eight years after the initial discovery and sometimes longer. Consequently, the discoveries through research over the past eight years have not, in most cases, reached our markets. It is predicted that in the next few years you will see startling new developments and many new products come on our markets which today are merely products in those minds familiar with research work which has been and is being done in industry.

Everyone knows that industrial research has great economic importance but the economic implications thereof are not well understood. The difficulty seems to be that most people think of research only as an instrument for increasing the capacity of industry to produce goods. That

is, of course, an important aspect of research. More important, however, is the fact that research affects our economy by discovering and developing new kinds of goods or improved goods. The development of such new goods encourages people to spend a high proportion of their income to obtain such new products. In developing such new products, the need for machines, buildings and labor to make the new kinds of goods will be increased, thus stimulating the spending on capital goods. In these several ways, technological research, stimulated to a great degree by the inducements offered by the Patent System, tends to raise the spending for consumption, new investment and replacements, and thus brings about an expansion and growth of our economy.

Supply and Demand for New Products

Another question that might be asked is—Is there any assurance that research will increase the demand for goods as rapidly as it increases the capacity of industry to make goods? In other words, can we be sure that in our kind of dynamic economy, which rapidly changing research and technology creates, supply will not outrun demand? It is possible in theory for supply to outrun demand even in an economy with a high level of industrial research, but such a result is unlikely in an economy such as ours. One reason, according to Professor Sumner Slichter of Harvard University, is that development of new inventions and technological progress quickly produces larger incomes for the workers, thereby increasing spending and buying power, and second, that nearly half of technological research is devoted to creating new products or processes. According to Slichter, a recent study of research of 191 large firms shows that about forty-four percent of the research expenditures had the purpose of creating new products or processes. New products, if intended for personal consumption, as a rule, tend to stimulate consumer buying and to discourage saving. Also, new processes are likely to require more complete scrapping of old plants and equipment, and cause larger investment expenditures than mere improvements in existing processes require. Based on this, one can well conclude that the rate of spending for new products will remain high and consequently, the economy will remain at a high level and will keep on expanding.

As stated before, the large research expenditures of the last eight years have not had time to produce a large quantity of commerically usable, new or greatly improved products or processes, but such improved products are on the way and are a good reason for expecting that the next few years will be unusually rich in new products and in new investment opportunities which will tend to create further expansion of our economy. So long as the incentive to obtain a patent monopoly for a limited time on the fruits of research is available, industry will be willing to continue to make tremendous risk investments as it had done in the past. In the absence of such research, one can readily visualize that

our people would not have the many good things of life which have been made available to us through invention, and that our industrial economy would not have reached the high state of development which is enjoyed in this country today.

America—The Nation of Inventors

In concluding, it should be reemphasized that the democratic basis of our Patent System has been and is a real inspiration, a stimulus and the incentive that has developed in the minds of individuals the many new and useful developments which constitute the foundation of our present high state of technology in our economy. America progressively has become a nation of inventors. This is largely because everyone has an equal opportunity to reap the reward for his original thought through protection by the limited monopoly granted under patents. The individual, as well as small business, may compete on equal terms with large institutions for success in the development and promotion of new inventions.

Many, but too few, of us realize that the United States Patent System has been one of the most important cogs in the machinery of developing technological improvements, industrial expansion and the wonderful system of free enterprise which has built up our country to the powerful place it occupies in the world today. We should recognize that the only means yet discovered for inducing the perpetual flow of inventions is the limited time protection granted to the inventor under the United States Patent System, and that the perpetual flow of invention has been the stimulus and base of our dynamic industrial development and expansion. In an address a few years ago, one of the leading industrialists in this country stated:

> "Were it my job as a super-saboteur to destroy America's future greatness, I can think of no more effective way than to destroy our Patent System. The fact is that if we permit impractical theorists and faddists to distort the facts and hypnotize our nation into this act of hari-kari, all of us will suffer and yet no adequate punishment can be meted out to those really responsible. Let us not by our inaction have any share in such a terrible responsibility."[7]

Continued Incentive Grant Will Preserve Our Strength

Today we are faced with many serious international questions, and are confronted with threats of war in several areas throughout the world. Notwithstanding this, we may still face the world with confidence for we still have political freedom and an industrial system built upon

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[7]Dr. Robert E. Wilson, Chairman of the Board, Standard Oil of Indiana, in an address upon being awarded the Perkin Medal in 1943, the main theme of the address being on the importance of patents in our economy.

the basis of a steady perpetual flow of invention into the public domain. We are the leaders of Western civilization with its hope for humanity and its message of freedom for the individual. As leaders, we are strong, and our strength politically is based upon our industrial strength, and our industrial strength, in turn, is based primarily on the incentive given through our domestic Patent System.

Great as are the material benefits which we receive from this induced flow of invention and the freedom of the inventor, the greatest is the self-perpetuation of the society permitting and encouraging them. We have seen nations rise and fall, but none had this induced flow of invention to bring out the best in its people. Our nation has passed through many great crises since 1776; individual freedom and this induced flow of invention have been of the greatest value in helping to save us. Our American Patent System is the only true inducer of the invention flow so far discovered and it must be preserved to maintain the continuing strength of our nation. Either weakening it or permitting it to be destroyed by those who would like to see us destroyed, therefore, is not merely a matter of slowing down our material benefits and our industrial progress, but it is actually a step toward national suicide.

MISSISSIPPI'S LEGISLATIVE APPROACH TO THE SCHOOL SEGREGATION PROBLEM

*William F. Winter**

When the late Justice Robert H. Jackson of the United States Supreme Court hinted an opinion by way of interrogation of counsel arguing the school segregation cases before the Court that a generation of litigation would probably follow a decision striking down segregation in the public schools of the nation,[1] he demonstrated perhaps a greater understanding of the extremely controversial nature of the segregation issue, particularly in the South, than it would appear that the Court did in its decision a few months later.[2]

For if the decision of the Court has had no other effect, it has set in motion the legal machinery of most of the Southern states to do just what most authorities who have had an accurate understanding of the relationships between the races in the South have predicted would follow such an event, and that is to endeavor to preserve by every legal means the maintenance of segregation in the school systems of the several states of the South. It has been to such an end that already two special sessions and one regular session of the Mississippi Legislature have devoted much of their attention in the space of less than a year, with another special session in prospect within a short time. Out of these serious deliberations have come a number of proposals, some enacted into law and others left unpassed, but all having as their primary purpose the continuation on a legal basis of a segregated school system in the State of Mississippi. It is not the purpose nor the scope of this article to argue the merits or demerits of these various pieces of legislation but rather to survey them briefly in the light of the determined purpose of most southern lawmakers to use their entire legal arsenal and all of their legislative ingenuity to forestall the implementation of the new standard of application of the Fourteenth Amendment's ever-lengthening yardstick.

Factor Affecting Legislation

In analyzing the specific legislative proposals there are a great many considerations that must be kept in mind on this highly complex matter. One factor which must be taken into account at this writing is the incompleteness of the Supreme Court's decision with respect to the plan of enforcement of its decree. As of now the decision stands simply as a sweeping and far-reaching statement of judicial policy on the broad general proposition of the unconstitutionality of school segregation. The questions which the Court posed with respect to the efficacy and means

*Attorney at Law, Grenada, Mississippi.

[1]*See* Brief for State of North Carolina as *Amicus Curiae*, p. 19, Brown v. Board of Education, 98 L.Ed. 583 (1954).

[2]Brown v. Board of Education, 98 L. Ed. 583 (1954).

of implementation remain so far unresolved.[3]

A second factor among the many others deals with that segment of the Fourteenth Amendment denoted by the term "state action" and the extent to which some of the ordinary functions of state and local government may be performed outside the formal agencies of government without invoking the prohibitions of that Amendment. This is a phase of the problem which must be taken into particular account in connection with some of the proposals calling for the operation of schools through non-governmental agencies and on a private or quasi-private basis. From a legal viewpoint this approach has been severely limited in recent years by such holdings as that in the case of *Rice v. Elmore*,[4] wherein the South Carolina primary election machinery, which operated completely outside the cognizance of state law, was declared to be unconstitutional, the Federal court saying in effect that the performance of a state function, by whatever device it might be accomplished, remained state action and was accordingly amenable to the standards established under the provisions of the Fourteenth Amendment. The Court has gone to rather elaborate ends to make certain that efforts to circumvent its authority in this regard are not successful. It has struck down as violative of the "equal protection" clause of the Amendment statutes which the Court conceded were fair and impartial on their face but the administration of which the Court found to be discriminatory.[5] The Court has on countless occasions discouraged attempts at avoiding its decrees by use of that well-established maxim that no purpose may be accomplished by indirection when its accomplishment by direct means has been forbidden.[6]

A third factor of particular significance involves the matter of the states' ability to exercise the very considerable authority which is theirs under the police power supposedly reserved to them by the Tenth Amendment,[7] without at the same time running afoul of the limitations

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[3]*Ibid.* The Court presented the following questions: "[4]Assuming it is decided that segregation in public schools violates the Fourteenth Amendment; (a) would a decree necessarily follow providing that, within the limits set by normal geographic school districting, Negro children should forthwith be admitted to schools of their choice, or (b) may this Court, in the exercise of its equity powers, permit an effective gradual adjustment to be brought about from existing segregated systems to a system not based on color distinctions?

"[5]On the assumption on which question 4 (a) and (b) are based, and assuming further that this Court will exercise its equity powers to the end described in question 4 (b), (a) should this Court formulate detailed decrees in these cases; (b) if so, what specific issues should the decrees reach; (c) should this Court appoint a special master to hear evidence with a view to recommending specific terms for such decrees; (d) should this Court remand to the courts of first instance with directions to frame decrees in these cases, and if so, what general directions should the decrees of this Court include and what procedures should the courts of first instances follow in arriving at the specific terms of more detailed decrees?"

[4]165 F.2d 387 (C.C.A. 4th 1947), *cert. denied*, 333 U.S. 875 (1947).

[5]Yick Wo v. Hopkins, 118 U.S. 356 (1886).

[6]11 Am. Jur. 724

[7]"The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

imposed under the "equal protection" clause of the Fourteenth Amendment. Within certain fields the police power of the states is a broad and extensive reservoir of authority[8] by which the states are empowered to prescribe regulations in promotion of the health, peace, morals, education and good order of the people.[9] The primary test required in the exercise of such power is one of reasonableness and whether the chief end is the accomplishment of a lawful public purpose.[10] In doing this it cannot be violative of the Fourteenth Amendment,[11] and of course it is here that the inevitable conflict on the instant problem is likely to occur in the Supreme Court. But it is also true that utilization of such power in the maintenance of continued segregation in the public schools would undoubtedly be the means of promoting the public safety of members of both races and the maintenance of peace and order. It not only is the privilege but the duty of each state to do all that is reasonably prudent to maintain order.[12] It is somewhat less than realistic to believe that integration in the public schools of the Deep South can be accomplished without a great many breaches of the peace with resulting injury not only in a physical sense to members of both races but also in an intangible way to the relatively harmonious relationships that have existed between the races in the South.[13] It is suggested, therefore, that the aforementioned test of reasonableness could be successfully met in any tribunal genuinely interested in pursuing the true purposes of the police power.

Assignment of Pupils

In the light of the foregoing considerations we turn, therefore, to some of the specific legislative proposals which have been advanced in recent months. The first enactment by the Mississippi Legislature dealing with this proposition was House Bill No. 45,[14] passed early in the 1954 Regular Session and prior to the Supreme Court decision. This bill establishes a procedure whereby local school boards shall make all assign-

[8]The Supreme Court of Washington in the case of State v. Mountain Timber Co., 75 Wash. 581, 135 Pac. 645 (1913), used the following language in referring to the police power: "The police power is to the public what the law of necessity is to the individual. It is comprehended in the maxim, *salus populi suprema lex*. It is not a rule, it is an evolution. . . . The power has always been as broad as the public welfare and as strong as the arm of the state. . . . The scope of the police power is to be measured by the legislative will of the people upon questions of public concern. . . (in statutes) enacted in affirmance of established usage or of such standards of morality and expediency as have by gradual processes and accepted reason became so fixed as to fairly indicate the better will of the people in their social, industrial and political development."

[9]Weaver, Constitutional Law and Its Administration 490 (1946).

[10]*Id.* at 493.

[11]Barbier v. Connolly, 113 U. S. 27 (1885).

[12]Chicago v. Sturges, 222 U. S. 313 (1911).

[13]In the North Carolina brief, *op. cit. supra*, note 1, at 8, it was reported that of 198 sheriffs and chiefs of police surveyed on the subject 191 "believe there would be likelihood of violence among racial groups of students which would seriously interfere with the operation of the schools."

[14]Miss. Laws 1954, c. 260.

ments of children within their districts to schools or attendance centers, such assignments to be based on "the educational needs and welfare of the child involved, the welfare and best interest of all the pupils attending the school or schools involved, the availability of school facilities, sanitary conditions and facilities at the school or schools involved, health and moral factors at the school or schools and in the community involved and all other factors which the board of trustees may consider pertinent, relevant or material in their effect on the welfare and best interest of the school district and the particular school or schools involved." In addition, there is spelled out in some detail the procedure which an aggrieved party shall follow, such procedure being the customary tenuous process of pursuing the administrative chain of command through the local school boards to the circuit court, where a *de novo* trial before a jury is provided for.

There can be no argument that on the basis of individual cases the boards of trustees could make a very strong showing of fact on which to defend their assignment of pupils under such a law. However, the eternal problem arises of whether the Supreme Court would, in the light of its prior decision, accept a law of this kind, where the broad effect of its application was to maintain a pattern of segregation.

Police Power

A more forthright and possibly more realistic approach to the problem was embodied in House Bill No. 59 of the Regular Session. This bill, which was recently adopted in principle by the people of the State of Louisiana as an amendment to their Constitution,[15] was not acted upon by the Mississippi Legislature and remained in the House Judiciary Committee at session's end. Its provisions boldly invoke the police power to prohibit the almost certain breaches of the public peace which would follow any intermingling of the races in the public schools of this state and declared that "it is incumbent upon the legislature in the exercise of the police power . . . to adopt such reasonable measures as may be necessary to maintain and preserve the public peace and to preserve and secure the personal safety, security, and tranquility of all the citizens of the state of all races." The measure then went on to define as a misdemeanor any act by a parent or school official permitting the intermingling of the two races in the schools of the state. If, as pointed out above, there is anything left of the rather considerable authority once deemed to be reserved in the police power of the states, it seemingly would not be too unrealistic to view this bill as a valid and proper exer-

[15]La. Acts 1954, No. 752, p. 54. This amendment contained the following wording: "All public elementary and secondary schools in the State of Louisiana shall be operated separately for white and colored children. This provision is made in the exercise of the state police power to promote and protect public health, morals, better education and the peace and good order in the State, and not because of race. The Legislature shall enact laws to enforce the state police power in this regard."

cise of state legislative authority in a field where certainly the health and public safety of the populace may well be at stake. Again, though, we are faced with the matter of, in effect, invalidating the application of a Supreme Court decision.

Constitutional Amendment

The most publicized enactment of the Mississippi Legislature and one which has been held out to be perhaps the state's most effective legal weapon in connection with this problem is House Concurrent Resolution No. 2,[16] adopted at the 1954 Extraordinary Session. This amendment to the State Constitution vests the Legislature with the specific power to abolish the public school system statewide by a two-thirds vote and in any school district or other local subdivision by a majority vote, such action being predicated on the immediate threat of integration. Proponents of the recently adopted proposal counseled that its use would be only on a "last ditch" basis and in the face of a situation which could be handled in no other manner. It was understood unofficially that a private school system would be expected to function in lieu of public schools, in the event that the latter were abandoned. The complete blue-print was not contained in the resolution, but a suggested procedure would include the transfer of physical school properties to private hands, with the financing of the system to be handled through public scholarship grants made directly to the pupils.[17]

In appraising this plan everyone must recognize that, as we have endeavored to point out earlier, the greatly enlarged scope of state action, as defined by the Supreme Court, now seems to include every activity wherein there is the slightest indication of state participation, either direct or indirect. While hope has been expressed by proponents of this amendment that it will never be resorted to, it is almost certain that should it be utilized, the final result of its invocation must inevitably be an absolutely bona fide private school system operating without any type of public assistance. The very serious question then arises as to whether an educational system so based could meet the demands of our modern society and its requirements for a universally literate citizenry.

Another argument for the amendment was suggested in connection with the possible need for revamping our state constitutional school provisions in the wake of the Supreme Court's decision on the segregation issue. Under previously existing sections of the State's supreme law a uniform system of free public schools is called for, and in addition under Section 207[18] is the requirement that separate schools be maintained for

[16]Miss. Laws, Spec. Sess. 1954, H.C.R. No. 2, p. 24.

[17]This was advanced in broad outline in an un-numbered report of the Legal Education Advisory Committee.

[18]Miss. Const. Art 8, § 207.

the children of the two races. Under one of the general rules of statutory construction which states that all sections of a constitution or statute dealing with the same subject matter shall be construed together,[19] it was suggested that the invalidating of Section 207 could carry with it the invalidation of all of the state's other provisions, both constitutional and statutory, with reference to the maintenance of a school system. There is, therefore, contained in the amendment provided for in House Concurrent Resolution No. 2 the following words: "Regardless of any provision of Article 8, or any other provisions of this constitution to the contrary, the Legislature may authorize the establishment, support, maintenance and operation of public schools." This provision may serve to clarify any doubt as to the legal status of the presently existing school system in our state in the event any prior section of the Constitution in that regard should be declared unconstitutional.

Other Proposals

A number of other proposals bearing directly or indirectly on this grave problem have been advanced from time to time. One device, which has been used for years in areas outside the South where segregation as a legal institution has long since departed, is the districting plan, whereby school districts are drawn to correspond to white and colored residential areas. There is, of course, no clear-cut rule as to how drastic a gerrymander may be in a case of this kind, but if the congressional districting patterns are followed, the sky is apparently the limit. In most of the smaller cities and towns and in practically all of the rural areas of this state, however, not even the most Dali-esque gerrymander could be contrived, for the intermingling of white and colored residences is too predominant there. This is not to say that it could not be employed in centers of concentrated population where geographical boundaries between the races could be fairly well defined.

More indirect but having a definite bearing on the general problem is the revision of the criminal statute defining conspiracy so as to include therein the following additional language: "To overthrow or violate segregation laws of this state through force, violence, threats, intimidation, or otherwise."[20] Such a provision is, of course, designed to discourage the efforts of any anti-segregationist to promote the integration of the schools and, like the broader proposal mentioned above, is bottomed on the state's police power.

Legislative Task

In analyzing these various propositions and others like them, it should be thoroughly understood by every legislator and administrator dealing with this problem that even though it is still too early to de-

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[19] 50 Am. Jur. 350.
[20] Miss. Laws, Spec. Sess. 1954, H.B. No. 58, p. 17.

termine what decree the Court will make with respect to the enforcement of its decree of last May, that decision has placed us in a position where any basis for permanently effective legal action to continue a general pattern of segregation in the schools must be grounded on a foundation which eliminates the question of color of and by itself as the sole determining factor. To those of us in the South who have an accurate understanding of the problem, such a foundation would seem attainable, since we recognize that very real and practical differences, other than that of color alone, exist between the races and that the interests of both races can best be served by observing those differences and their separate needs in a system of separate schools. The difficulty, of course, is that the same tribunal that pronounced the original decision will be the self-same final arbiter in the determination of the legality of subsequent action by the various states in their endeavors to minimize the effects of the anti-segregation decision. We must understand, therefore, if plans to continue compulsory school segregation as a legal institution are to be more than merely dilatory steps susceptible of being invalidated by the Court in their first test, and possibly it is unrealistic to regard them as more than that, they must be solidly based on a constitutional principle which the Court will recognize as valid. It goes without saying that such a task is not a simple one. Perhaps, it would be more frank to regard it as an impossible one. But whether these proposals be finally held valid or not, one thing remains certain—there will be no dearth of effort in searching for a legal solution, and even though it may never be found, the courts will undoubtedly be kept busy for at least that generation, of which the late Justice Jackson spoke, declaring invalid the products of legislative labor.

Such a purpose on the part of state legislators intent on maintaining segregation in the schools is, of course, not inconsistent with our philosophy of government and our system of laws in this country. These legislative efforts are an established part of our legal framework This idea was very forcibly expressed to the Supreme Court in the brief filed recently in the segregation cases by the State of North Carolina as follows:

> Many of our principles of law and of our philosophy of government were hammered out through not one, but many generations of litigation. A generation of litigation is far preferable to the destruction of a social order which is the product of many generations of free men and women striving together for their mutual advancement. A generation of litigation is preferable to a generation of bitterness and strife between neighbors outside the courts, to a generation of chaos inside the schoolroom, or a generation with no public schools at all.[21]

[21]North Carolina Brief, *op. cit. supra,* note 1, at 19.

Conclusion

And at the same time that we are looking for a remedy at law, it seems not unlikely that we shall find that in many areas of the South the very pattern of life of the people themselves based on mutually-understood and well-established customs, will provide, even in the absence of legal compulsion, a satisfactory means of maintaining segregation in the schools. If this be deemed a part of the answer to the problem, as surely it must, it must be abetted by resolute action, now encouragingly begun, to further develop and equalize the educational opportunities for the children of both races. For when all is said and done, the pressure for change loses much of its force when the desirability for change is not so apparent. And in the final analysis, this enhancement of educational opportunity should have our attention not only because it is expedient but because it is right.

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Student Comments

Extending Corporate Limits

Mississippi, long a rural area, is experiencing a gradual but increasing change into a more urbanized region. As mechanization of agriculture continues, new industry moves in, and old industry expands; the small towns and cities of the area feel increasingly, the growing pains of changing times. This inevitably leads to the need for more space, and an extension of the corporate limits.

Such attempts for expansion may be, and often are, bitterly contested by the inhabitants of the proposed new territory who, are undesirous of being burdened with city taxes. The usual intensity of opposition makes these actions long, bitter contests with friction becoming acute and people of the community splitting into vociferous, antagonistic groups. To meet the problem of expansion while at the same time reducing friction to a minimum, a thorough understanding of the legal procedure necessary to effectuate the expansion is most desirable so that a more orderly and efficient means of terminating the dispute may be attained. It is with this need in mind that the following study has been made.

Power to Expand

In order to properly understand the problem of expansion and its legal foundations, a brief look should first be given to the source of the power to expand and the delegation from that source to the governmental organs which effectuate the problem. Since municipal corporations are mere creatures of legislative enactment, the legislature, in absence of constitutional limitations, may create and abolish them at will.[1]

This power, and corresponding limitations, is expressed as follows in the Mississippi Constitution:

> "The legislature shall pass general laws, under which local and private interests shall be provided for and protected and under which cities and towns may be chartered and their charters amended, and under which corporations may be created, organized, and their acts of incorporation altered; and all such laws shall be subject to repeal or amendment."[2]

This section has been held to be mandatory on the legislature, compelling statutory enactments to fulfill this need.[3]

Incidental to the above powers of the legislature over municipal corporations is the additional power to prescribe methods of annexation or alteration in municipal boundaries.[4] This power is generally considered absolute; and in the absence of constitutional limitations,

> " . . . the legislature has power to extend the boundaries of a municipal corporation . . . without the consent of the inhabitants of the territory annexed, or the municipality to which it is annexed, or even against their express protest."[5]

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[1]37 Am. Jur. 645.
[2]Miss. Const. Art. IV Sec. 88.
[3]Monette v. State 91 Miss. 662, 44 So. 989 (1907).
[4]37 Am. Jur. 645.
[5]64 ALR 1336; 37 Am. Jur. 639. See Martin v. Dix, 52 Miss. 53 (1876) at p. 62.

This power of expansion has been delegated by the legislature through statutory enactments to the municipal governments, provided certain procedures and requirements are met. A municipal corporation has no power to extend its boundaries not derived from the statutory delegation.[6] The authority to determine when conditions exist which warrant an extension and whether the proper procedure has been followed in complying with the statutes on extension is generally considered a judicial function and properly conferred on the courts.[7] The question often arises, however, as to when the process of finding whether the needed conditions exist for expansion ceases to be judicial and encroaches on legislative authority, which cannot be so delegated.[8]

The statutes, then, as delegations of power from the legislature, are the modes whereby the power to expand is put into practical operation and these then become the focal points of study in a thorough analysis of the problem.

Mississippi Statutes

For over fifty years, the procedure for extending corporate limits was governed by sections 3376-3383 of the Mississippi Code of 1942. By these statutes, the expanding municipality would pass an ordinance, declaring and defining the extended boundary,[9] and after due publication and one month from passage, the ordinance would become effective unless challenged.[10] Challenge was made in circuit court before a jury with the issue being the reasonableness of the ordinance.[11] Proper avenues for appeal were allowed.[12]

In 1950 by House Bill 71, these statutes were repealed and a new procedure set forth.[13] The new act provides that an extension ordinance as passed by the municipality must include:

1. A definition with certainty of the territory proposed to be included in the corporate limits.
2. A description of the entire boundary as changed.
3. Proposed improvements to be made in the annexed territory.
4. The manner and extent of such improvements, and the approximate time in which they are to be made.
5. A statement of muncipal and public services the municipality will render to the annexed territory.[14]

After passage of the ordinance, the municipality then files a petition in chancery court seeking its approval. A hearing follows,[15] a decree is rendered, and appeal is allowed as in other cases.[16]

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[6]37 Am. Jur. 640.
[7]37 Am. Jur. 641.
[8]Miss. Const. Art. 11 Secs. 1, 2 See Ritchie v. City of Brookhaven, 217 Miss. 860, 65 So. 2d 832 (1953).
[9]Miss. Code Ann. (1942) Sec. 3376.
[10]Miss. Code Ann. (1942) Sec. 3377.
[11]Miss. Code Ann. (1942) Sec. 3379.
[12]*Ibid.*
[13]Miss. Code Ann. (1942) Secs. 3374-10 through 3374-20. For discussion of changes made, note 22 Miss. L. J. 83, 84.
[14]Miss. Code Ann. (1942) Sec. 3374-10.
[15]Miss. Code Ann. (1942) Sec. 3374-12.
[16]Miss. Code Ann. (1942) Sec. 3374-13.

The problem, as in every case, arises in applying the statutes to practical situations. Only two cases have reached the Supreme Court of Mississippi concerning the new enactments;[17] but they have had vast import in determining its meaning and construction and the extent to which rulings made under the old statutes still apply. A few of the major problems need to be considered.

The Ordinance

An important ruling concerning the content of the ordinance was announced in *Ritchie v. City of Brookhaven.*[18] The city ordinance listed general improvements to be made, qualified by such phrases as "where necessary and economically feasible," and "within three years . . . unless delayed by war or military preparedness restrictions." The Court upheld the validity of the ordinance saying:

> "Under the express provisions of the act in question, it is required only that the ordinance shall *in general terms* describe the improvements to be made and the manner and extent thereof, and we think that the ordinance in question meets these general requirements. The ordinance sets forth the improvements to be made in the annexed territory, describing them in general terms and providing that they will be made where necessary and economically feasible."[19]

In *White v. City of Drew, supra,* the question concerning the definiteness of the ordinance was also raised. The Court declared,

> "The statute does not require a municipality prior to executing its ordinance of extension to ascertain the precise costs of improvements and the sources from which the town will obtain . . . materials. . . . The statutes require the ordinance to set up 'the approximate time within which the improvements are to be made,' and the chancery court to find that the improvements will be made 'within a reasonable time.' The use of the phrases 'approximate time' and 'reasonable time' indicate a legislative intent to vest a broad area of discretion in the governing body."[20]

Thus it can be seen that the tendency is liberally to construe the statutory requirements concerning the content and form of the ordinance.

Tests of Validity

Under the old Mississippi statutes concerning extension, the test presented to the jury in determining the validity of the ordinance was " . . . whether the proposed . . . extension . . . of the municipality . . . be or be not unreasonable."[21] In determining this question the jury had to consider the extension as an entirety and could not allow admission of only a portion of the property under consideration.[22] A number of changes in these tests were established under the new statutes, under which the proceeding is held before the chancellor. To uphold the ex-

[17]White v. Town of Drew, 214 Miss. 147 (styled as Parker Gin Corp. v. Town of Drew, 58 So. 2d 372) (1952); and Ritchie v. City of Brookhaven, 217 Miss. 860, 65 So. 2d 436 and 65 So. 2d 832 (1953).

[18]Ritchie v. City of Brookhaven, *supra* note 17.

[19]*Id.* at 874.

[20]White v. Town of Drew, *supra* note 17 at 151, 152.

[21]MISS. CODE ANN. (1942) Sec. 3379.

[22]Forbes v. City of Meridian, 86 Miss. 243, 38 So. 676 (1905).

tension the statute declares that the chancellor must find that " . . . the proposed enlargement . . . is reasonable and is required by the public convenience and necessity and . . . that reasonable public and municipal facilities will be rendered in the annexed territory within a reasonable time."[23] The statute further provides that the chancellor may grant the extension in whole or in part,[24] another change from the old provisions.

The constitutionality of the new requirements was quickly challenged with partial success in *Ritchie v. City of Brookhaven*.[25] One of the questions concerned the chancellor's authority to determine whether the extension was required by public convenience and necessity. The Court on rehearing declared, " . . . it is our view that he cannot pass on the legislative question of public convenience and necessity, which was for the municipal board in adopting the extension ordinance."[26]

The power of the Chancellor to modify the enlargement was also challenged as an invalid grant of legislative power, but this attack was rejected by the Court in the following words:

> "It is to be noted, however, under this particular provision of the act, that the court has no power to enlarge the proposed annexed territory. Its power to modify the enlargement is only to the extent of reducing the enlargement in the event it should be found by the chancellor from evidence presented that some part of the proposed annexed territory is unreasonable and should be eliminated."[27]

When the statutes are re-examined in view of the constiuttional restrictions invalidating the "public convenience and necessity" tests, it can readily be seen that the chief test remaining before the court is the same as under the old statutes, the "reasonableness" of the ordinance.[28] Thus, cases determining "reasonableness" under the old statutes become authority under the new statutes today. It might be well then to examine some of the factors considered in past cases on this question.

Reasonableness

The test of the "reasonableness" of an extension ordinance varies in each particular case, dependent on the various favtors involved. However, over a period of years, a number of cases dealing with this subject have established at least to some degree a pattern concerning matters most often considered.

The landmark case on this problem in Mississippi is *Forbes v. City of Meridian*,[29] decided in 1905. The Court, in outlining the problem to be considered by the jury declared:

> "The power of extending corporate limits is granted, not to be resorted to for the purpose alone of increasing the income of the municipality, but in order that the benefits incident to civic government may be extended to those resident in the territory adjacent to the municipality and included in the extension; its sanitary and

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23Miss. Code Ann. (1942) Sec. 3374-13.
24*Ibid.*
25Ritchie v. City of Brookhaven, *supra* note 17.
26 *Id.* at 878.
27*Id.* at 873.
28For a discussion of tests used in other jurisdictions, note 62 ALR 1011.
29Forbes v. City of Meridian, *supra* note 22.

> quarantine regulations, and its more adequate fire protection, may thereby conserve the best interests of the inhabitants within its original borders, and also give to those living in the territory included in the extension more efficient protection against devastation by fire, and by the enforcement of necessary sanitary regulations to the public health decrease the danger from disease and pestilence. These are the paramount consideration, and incidental to these the citizens included in the extension are entitled to share in common with the other inhabitants of the municipality the conveniences of sidewalks and lighted streets, fire protection, and all other advantages of city life."[30]

This test has been followed since that time and is authority today under the new statutes.[31]

In *Town of Crystal Springs v. Moreton*,[32] decided in 1922, an instruction provided in part that " . . . unless the jury believe . . . that the territory proposed to be included is necessary to be included in the corporate limits for some other purpose than taxation and revenue arising therefrom, then your verdict should be against the extension." The Court declared this to be grounds for reversal, saying that the test is whether the ordinance is reasonable and not whether it is necessary. Evidence presented on reasonableness included the number of people in the territory, the type land to be included, the growth of the town, the availability of building space in the town, and the ability of the town to provide police and fire protection.

By 1947 the problem of expansion was increasing in occurrence as urbanization in Mississippi advanced. The Court in *Walker v. Town of Waynesboro*[33] expressly followed the principles announced in *Forbes v. City of Meridian, supra*, in examining the evidence offered, and declared,

> "The entire record sufficiently reveals a purpose toward and a probability of benefit both to the citizens of the old and of the new areas, as interpreted by the Forbes case, to justify the verdict of the jury."[34]

The next year in *Kennedy v. City of Kosciusko*,[35] questions relating to taxation as a factor were considered Evidence concerning future taxation of the property by the city was not admitted for consideration by the jury, and the Court declared that these rulings were not error.[36] Other factors considered in the case involved the physical nature of the proposed area, the financial condition of the municipality, and the individual reactions of the protestants. The number of residents in the area, the use of city schools, the availability of water and lighting facilities in the area, and the suitability of the area for residences were also considered in determining the reasonableness of the ordinance.

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[30]*Id.* at 252, 253.

[31]White v. Town of Drew, *supra* note 17.

[32]Town of Crystal Springs v. Moreton, 131 Miss. 77, 95 So. 242 (1922).

[33]Walker v. Town of Waynesboro, 202 Miss. 830, 32 So. 2d 455 (1947).

[34]*Id.* at 837.

[35]Kennedy v. City of Kosciusko. 203 Miss. 4, 33 So. 2d 285 (1948).

[36]Taxation of incorporated property during the taxable year in which incorporated had already been disallowed in City of Gulfport v. Todd, 92 Miss. 428, 46 So. 541 (1908). This rule is expressly included in the new statutes. MISS. CODE ANN. (1942) Sec. 3374-28.

In 1950, the problem of reasonableness again reached the Court in *Nicholson v. Town of Booneville.*[37] The decision involved, ". . . the extent of the interests which are to be served in the new area and the capacity of the municipality reasonably to furnish such benefits."[38] The objectors presented evidence showing their disinclination to come in, announced their satisfaction with their present status, and challenged the city's ability to furnish the promised facilities. The city to meet the test promised improvements in streets and sidewalks, water and sewage facilities, police and fire protection, and garbage disposal. The nature of the land was also considered. In effect the efforts of both sides were stated by the Court in the following words:

> "The objectors minimize both the needs and the ability of the town to meet them, while the testimony for the town emphasized both the necessity and its capacity to furnish such improvements."

The Court decided the issue on the principles laid down in *Forbes v. City of Meridian, supra, Walker v. Town of Waynesboro, supra; and Kennedy v. City of Kosciusko, supra,* and upheld the reasonableness of the ordinance.

The last case reaching the Court under the old statutes was *Ball v. City of Louisville,*[39] decided in 1952. The chief obstacle before the city in presenting its proof of benefits to be given to the inhabitants of the proposed annexed territory stemmed from the fact that the city was already supplying many of the necessary facilities, including water and fire protection, to the area, and the area was well provided with other benefits from private sources. Other questions included the suitability of the land for residential purposes and the financial ability of the city to make the offered improvements. The chancellor (the cause was heard before the chancellor by special agreement), nevertheless, ruled that the ordinance was reasonable. The Court, in upholding the decision, again reviewed and followed the tests of *Forbes v. City of Meridian, supra,* and the subsequent cases adhering to the ruling.

The first case under the new statutes to reach the Court was *White v. Town of Drew,*[40] decided in 1952. On the issue of the reasonableness of the decree, the old tests of *Forbes v. City of Meridian, supra,* and *Ball v. City of Louisville, supra,* were applied, and thus made precedents under the new statutes. Declaring that the new residents would obtain fire protection, sewerage, water, streets, services of an insect fogging machine, garbage removal, police protection, and sanitary improvements, the Court affirmed the chancellor's ruling that the ordinance was reasonable. Again the objectors' principal evidence tended to show that the area was already receiving most of the benefits, either from the city or from private sources.

The nature of objectors' evidence in recent cases presents an interesting question concerning its possible effects on the policy of a municipality toward an outlying area. Using present courts tests, services rendered a suburban area by a municipality may well tend to later defeat an action by the municipality seeking to expand. This might conceivably

[37]Nicholson v. Town of Booneville, 208 Miss. 800, 45 So. 2d 594 (1950).
[38]*Id.* at 803.
[39]Ball v. City of Louisville, 56 So. 2d 4 (Miss. 1952).
[40]White v. Town of Drew, *supra* note 17.

cause vigilant municipalities to refrain from rendering those services in order to be able later to better incorporate the territory. With the increasing number of suburban districts in Mississippi, it is submitted that such a result would not be in the best interests of the state. It might prove wise to credit a municipality in such cases with the benefits that it is then providing to the area.

Nevertheless, the tests of reasonableness seem here to stay.

Burden of Proof

Perhaps the most interesting question arising from the new enactments concerns the burden of proof. Under the old statutes, the burden of proof was firmly established on the objectors. As early as 1922, in *Town of Crystal Springs v. Moreton*,[41] the Court, in determining which side was entitled to open and close the arguments before the jury, declared as follows:

> "We think that in such contests the burden of proof would be upon the parties contesting the extension. When the town passed its ordinance proposing the extension, the presumption should be indulged that the extension was reasonable and proper. Those who contest the right to so extend ought to have the burden of proving that the ordinance is unreasonable, and the burden of proof gives the right to open and close the case."[42]

The decision was followed in *Walker v. Town of Waynesboro*,[43] and *Vail v. City of Jackson*,[44] and reiterated finally in *Ball v. City of Louisville*[45] in the following words:

> "Now, in the case at bar, the board of mayor and aldermen, by passage of the ordinance proposing to add the new territory, adjudicated that the extension is reasonable. The burden was upon the objectors to overturn this and show such extension to be unreasonable."[46]

Thus the burden of proof was placed squarely upon the objectors up until the passage of the new act in 1950.

The new statute, however, in describing the procedure to be followed before the Chancery Court, declares,

> "In any proceeding under this section the burden shall be upon the municipal authorities to show that the proposed enlargement or contraction is reasonable."[47]

This provision logically led some observers to believe that the burden of proof had now shifted to the municipality and that the older decisions had been overturned.[48]

But a rather surprising decision followed. In the first case to reach the Court regarding the new statutes,[49] this precise point was raised. The

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[41]Town of Crystal Springs v. Moreton, *supra* note 32.
[42]*Id.* at 89.
[43]Walker v. Town of Waynesboro, *supra* note 33.
[44]Vail v. City of Jackson, 206 Miss. 299, 40 So. 2d 151 (1949).
[45]Ball v. City of Louisville, *supra* note 39.
[46]*Id.* at 9.
[47]MISS. CODE ANN. (1942) Sec. 3374-13.
[48]Note 22 MISS. L.J. 84.
[49]White v. Town of Drew, *supra* note 17.

Court proceeded to quote the first portion of section 3374-13 but omitted the last sentence relating to the burden of proof. Then following the rule announced in *Ball v. City of Louisville, supra,* the Court declared,

> "In considering the issues raised on this appeal it should be kept in mind that the board of mayor and aldermen, by the passage of the extension ordinance, adjudicated that the extension was reasonable; that the burden was on the objectors to overturn this and show such extension to be unreasonable; and that the chancellor found that they had not done that . . . . Hence appellants are in error when they say that the burden of proof was on the town."[50]

This startling result may not yet be firmly established as the prevailing rule, however. In one lower court proceeding,[51] when faced by this question, Special Chancellor L. G. Fant, Jr. refused to follow the decision. After quoting the statute[52] relating to burden of proof and discussing *White v. Town of Drew*[53] (cited in Southern Reporter as *Parker Gin Corp. v. Town of Drew* and so referred to) the following ruling was made:

> "No mention by the Court is made of the statutory words in 3374-13 quoted above. This court feels bound to hold that if the Supreme Court had intended to change the meaning of the last sentence of 3374-13, some reference would have been made by the Court. Since the cases cited by the Court in *Parker Gin Corporation v. Town of Drew* were decided under the old statute in which the burden was on the objectors, it appears that the statute will hold and the burden will be upon the municipal authorities and that will rule."[54]

Unfortunately this case never reached the Supreme Court for a definite ruling on this point, and so the issue at present is still in doubt.

Other Problems

Other problems of equal importance also may arise in connection with corporate extensions; for example, questions concerning the consolidation of two municipalities or involving the incorporation of a state institution into a municipality. These matters come up much less frequently, however, and will thus be but briefly mentioned here.

Under the old statutes, provisions allowing two municipalities to unite were combined within the same sections allowing extensions of municipalities into unincorporated territory.[55] Only a few cases arose relating to the problem, and each presented an individual question not generally applicable to future proceedings.[56] The new act separates consolidation proceedings into a separate section.[57] As under the old statutes,

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[50]*Id.* at 151.

[51]In the Matter of the Contraction and Extension of the Corporate Limits of the City of Pontotoc, Mississippi. Chancery Court of Pontotoc County, No. 6908, June Term, 1952.

[52]MISS. CODE ANN. (1942) Sec. 3374-13.

[53]White v. Town of Drew, *supra* note 17.

[54]In the Matter of the Contraction and Extension of the Corporate Limits of the City of Pontotoc, Mississippi, *supra* note 51. From transcript of stenographic notes, p. 6.

[55]MISS. CODE ANN. (1942) Secs. 3376-3380.

[56]Fabric Fire Hose Co. v. Board of Aldermen of City of Vicksburg, 117 Miss. 89, 77 So. 911 (1918); and City of Pascagoula v. Krebs, 151 Miss. 676, 118 So. 286 (1928).

[57]MISS. CODE ANN. (1942) Sec. 3374-17.

both municipalities must pass ordinances approving the unification; however, their validity is now tested in Chancery Court, in the manner of other extension proceedings.

The other problem involves the incorporation of a state institution into a municipality. The original statute,[58] forbidding such incorporation without consent, was repealed in 1950,[59] but was virtually reenacted[60] with little change in wording under the new act. One case[61] concerning this problem arose under the old statute, with the question involving the time of creation of a state institution. The Court ruled that there was no state institution on the property until the Building Commission completed and conveyed the property to the Board of Trustees of the institution.

One new way of extending corporate limits was established by the new statute.[62] Two-thirds of the qualified electors of a territory may, in lieu of a city ordinance, petition to the Chancery Court to have the territory included into the municipality. Tests used in determining this question are the same as in other cases on extension. No cases have yet arisen using this new procedure.

Territory may also be excluded from municipalities. Statutes dealing with expansion conversely also contain methods of contracting municipal boundaries. Except to say that the procedure is generally the same as that followed in extension proceedings, this problem will not be treated here.

Conclusions

The new extension statutes, designed to meet an increasing problem in Mississippi, while making certain basic procedural changes, have nevertheless created little change in the proof to be offered and the tests to be used. The old factor concerning the reasonableness of the ordinance yet controls, with the tests long ago established under the old statutes still being accorded full authority. The question of burden of proof remains unsettled, with an apparent conflict at present between statutory language and the most recent Court decision. As urbanization continues and an increasing number of cases reach the Court, this conflict will no doubt shortly be settled. But the tests of reasonableness declared in *Forbes v. City of Meridian*[63] seem firmly embedded in Mississippi law for a long time to come.

Irby Turner, Jr.

58MISS. CODE ANN. (1942) Sec. 3383.
59MISS. CODE ANN. (1942) Sec. 3374-33.
60MISS. CODE ANN. (1942) Sec. 3374-18.
61Vail v. City of Jackson, *supra* note 44.
62MISS. CODE ANN. (1942) Secs. 3374-19, 3374-20.
63Forbes v. Meridian, *supra* note 22.

RECENT DECISIONS

INTERNAL REVENUE — NINTH CIRCUIT UPHOLDS NEW SCHEME FOR TAX AVOIDANCE BY COOPERATIVE MEMBERS.

Petitioners were members of a cooperative fruit growers association, through which they marketed their peaches in a pool plan. When the peaches were sold, the net proceeds, less an association charge, were distributed to the members on a basis of participation. The Association charge after payment of expenses was carried into a capital reserve fund; and, in addition to the cash distributed, the members also received, on the basis of participation, interest-bearing, negotiable certificates representing their interest in the capital reserve, which certificates would be redeemed in cash at a time specified by the board of directors. HELD: These certificates were not taxable as income for the year of their receipt, overruling the decision of the Tax Court to the contrary. *Estate of Caswell v. Commissioner,* 211 F.2d 693 (9th Cir. 1954).

The effects and ramifications of this important tax decision cannot be examined or appreciated without looking into some of the fundamental principles of tax theory and the peculiar situation brought up by this case. The system of double taxation of the dividends of a corporation has been one of the time-worn complaints of taxpayers. This "double tax" arises because of a levy on the income of the corporation, as such, followed by another tax on the same increment as income to the shareholders in the form of a dividend.[1]

Many methods have been employed in attempting to avoid taxation at one place or the other, some to relieve the corporation of tax liability on its profits and others to remove taxes on the individual shareholder who receives the dividend. One of the chief methods of removing taxability from the corporation is to form it as a cooperative so as to escape tax liability under Section 101 (12) of the old Internal Revenue Code of 1939 or Sections 521, 522 of the 1954 Code, which exempt certain farmers' cooperatives of the natures of the one in this case from tax liability on cooperative's proceeds.[2] Another exemption, applicable to all cooperatives, is based on the theory that the cooperative is not a taxable entity itself, capable of receiving income, but is merely a "conduit" to channel income to its members.[3] Another way these cooperatives escape tax liability is on the theory that the proceeds above expenses should be taxed as income, but an equivalent figure is deductible as the amount due to the individual members, thus erasing any taxable income by charging the profits to legal liabilities to the members and thus deducting the full amount from taxable income to the corporation, (cooperative).[4] Still another theory, sanctioned by the courts, is the escape device used by purchasing associations which classifies payments out of the cooperative's proceeds back to the purchaser-members as rebates or "patronage refunds" and thus shows those amounts to be part of the purchase price which is never taxable.[5]

In avoiding taxation at the other end, certain corporations have been successful in protecting their shareholders against taxation on dividends by declaring those dividends in the form of stock increases rather than cash payments. By this method, the corporation transfers to it shareholders new issues of stock on a pro rata basis,

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[1]The Revenue Code of 1954 has modified this system of double taxation by statute. INT. REV. CODE (1954) §§ 34, 116

[2]INT. REV. CODE (1939) § 101 (12); INT. REV. CODE (1954) §§ 521, 522.

[3]"An income tax is not assessable against a corporation if its net income for the past fiscal year is includible in stockholders' personal returns of taxable income for that year." Helvering v. National Grocery Co., 304 U. S. 282 (1938).

[4]Revenue Act of 1918, 214; Revenue Act of 1921, 212 (a), 214 (a), 42 Stat. 251 (1921); Brown v. Helvering, 291 U. S. 193 (1934).

[5]P-H TAX SERV. ¶ 7111.

such as two new shares for each existing share.[6] This method has been upheld by the courts as not taxable to the individuals as income. The doctrine is based on the theory of "proportional interest."[7]

The peculiar situation dealt with in this case is a scheme which combines and somewhat distorts the methods explained above to avoid taxation of either the corporation (cooperative) or of the individual members. This decision was rendered against the commissioner who sought to tax the estate of a member for certificates issued to that member representing money on deposit for him in a capital reserve pool of a tax-free farmer-cooperative. The certificates were both negotiable and interest-bearing. The court of appeals, in reaching a decision for the petitioner, based its opinion on the fact that these certificates were not redeemable in cash on demand but could only be paid in cash at the election of the board of directors of the cooperative. It is very important to an accurate analysis of this case situation to realize the importance and consequences of this right of election of time of payment by the board. The cooperative has already been exempt from taxation on the sums represented by these certificates by charging that amount off as due its members, although actual payment and the time of payment was to be solely determined by the election of the board of directors. It will be noted that in the methods outlined above for the avoidance of taxation on a corporation because of later taxation to individual shareholders, each corporation or cooperative was under a mandatory obligation to pay the money over to the shareholders.[8] Such was not true in this case for the payment was at the election of the board of directors. As to why the cooperative wished to issue the certificates, it was probably to avoid an accumulation of a large surplus. That would be undesirable for two reasons: (1) there is a danger of a heavy penalty tax for the accumulation of a large surplus,[9] and (2) the cooperative would then begin to look like a regular profit making corporation rather than a cooperative and might be held to fall within the scope of taxes on corporate income and no longer able to escape that taxation by claiming to be a cooperative "conduit."[10]

According to the court in the instant case, the fact that the certificates were redeemable in cash only at the election of the board of directors made them represent no more than a contingent right to a definite sum, and thus tax could not be levied on them until the sum was paid in cash.[11] The court here attempted to use the pro-

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[6]Tourtelot v. Commissioner, 189 F.2d 167 (7th Cir. 1951).

[7]This doctrine, first espoused by Mr. Justice Holmes in his opinion in Towne v. Eisner, 245 U. S. 418 (1918), holds that the individual shareholder is not to be taxed on the value of the new stock that he has been issued because his proportional interest in the total value of the corporation has not been increased by the issuance of this new stock. This theory is fully explained by the United States Supreme Court in the case of Eisner v. Macomber, 252 U. S. 189 (1919), which is considered the leading tax case in this field. The "proportional interest" doctrine reaches its result on this reasoning: if a corporation issues new stock to eradicate a surplus and issues it on a pro rata basis, each shareholder increases his holdings in the same proportion as the real representative value of each share decreases in value. Thus, while the stock dividend might result in each shareholder's owning three times as many shares of stock, his proportionate interest or true monetary interest in the corporation has not increased because each of his shares in that case is now worth only one-third as much, since three times as many shares represent the same amount of wealth.

[8]San Joaquin Valley Poultry Assn. v. Commissioner, 136 F.2d 382 (1943); Amer. Box v. Commissioner 156 F.2d 629 (1946); Assoc. Growers of Ala. v. Willingham, 77 F. Supp. 990 (1948).

[9]INT. REV. CODE (1939) 102; I.R.C. (1954) §§ 531, 532. Although no cases are available which hold that a cooperative could be included in the corporations effected by this surtax, there is no specific exemption of them and it seems reasonable to assume that they might, if they lost their exempt status and were treated as ordinary corporations.

[10]P-H TAX SERV. ¶ 4424.

[11]Caswell's Estate v. Commissioner, 211 F.2d 693, 696 (9th Cir. 1954).

portional interest theory to excuse petitioner from taxation by saying that each member of the cooperative had just as great an interest through his member's equity in the capital reserve before the certificates were issued as after the issuance. Thus, in the words of the opinion, "The certificates did not give Wallace Caswell . . . any new right or any greater right than they had before the certificates were issued."[12] The ingenious device was approved and the proceeds of a successful business operation were received by the cooperative and passed on to its members without any income tax on either party.

At first glance, the reasoning of this court might appear sound, but it is the opinion of this writer, that the court overlooked some very important considerations in this case and thus reached a decision completely out of harmony with our current tax principles. To say these certificates were not in themselves income, until such time as they could be cashed, completely disregards a case earlier decided oppositely by this same circuit court on the same type of issue.[13] This is also violative of the result reached on the same issue by the Tax Court in several heretofore uncontroverted decisions.[14] A recent, untested decision sets out as a test of the taxability of such certificates whether or not they are negotiable, it being held that they are taxable if negotiable and not taxable if non-negotiable.[15] Viewing the true crux of this issue, that distinction would seem to be invalid as a positive guide and only a circuitous method of determining that some certificates are taxable because they have a market value while others have no current market value and thus are not taxable. Certainly a good indication of whether market value exists currently or not is whether the certificates may be exchanged, negotiated and used for security.

The argument of *Eisner v. Macomber*[16] as applied to this situation is interesting and must be met to justify a decision for the commissioner. The apparent reason that this doctrine is not properly applicable here is that it was devised for and has heretofore been applied only to situations relieving an individual's taxability on the increment of a capital investment which had already been taxed as the income of the corporation. Here the amount in question was not income to the corporation, has never been taxed to the corporation and so was not properly an increment of the capital investment of the individual cooperative members but was actually income channeled to the individual by the conduit of the cooperative. Therefore, it is this writer's opinion that the doctrine of *Eisner v. Macomber* should not be applied to this situation.

This case is an outstanding illustration of what can happen in the field of tax decisions when certain sums can be classified as borderline cases for taxation ot the corporate organization, not taxed to the corporation because it is looked upon as merely channeling the income directly to its members, and then the same sums examined by the courts in the light of their taxability to the individuals. When this is done, the courts decide that the amounts are not taxable to the individuals because they do not really receive them as income but only have additional evidence of their proportional equitable interest in the assets of the corporation. Two inconsistent views are upheld, both of them to the advantage of taxpayers, both of them to the detriment of the commissioner. On the one hand the corporate organization is looked upon as a mere conduit, incapable of receiving income for itself; on the other hand, it is called a corporate entity, the increased equity in which cannot be called income

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[12]Caswell's Estate v. Commissioner, *supra* note 11, at 696.

[13]Harbor Plywood Corp. v. Commissioner, 167 F.2d 734 (9th Cir. 1951).

[14]Joplin v. Commissioner, 17 T.C. 1526 (1952); Colony Farms v. Commissioner, 17 T.C. 688 (1951); Bradshaw v. Commissioner, 14 T.C. 162 (1950).

[15]B. A. Carpenter Case, 20 T.C. (No. 82) (1953).

[16]P-H Tax Serv. ¶ 7111.

[17]*Supra,* note 6.

to the individual. Thus, a strange anomaly of the law is seen in this case.

The decision here opens an entire new field for the planning of business operations so as to delay the payment of taxes on income for any certain period, to spread one's income tax payments over the most desirable period of time, and to completely escape the payment of income tax on the increment in value represented by the negotiable certificates if, as was the case here, the members of the cooperative should die prior to the cashing of the certificates. This is because the heir or legatee gets a stepped-up basis equal to fair market value of the property at the time of decedent's death, thus avoiding taxation on the increment caused by the profits represented by the certificates.

For an agricultural economy, such as Mississippi's, the plan is worthy of careful study, for it is a valuable basis for planning marketing operations to minimize taxation, if this decision is upheld.

Hunter M. Gholson

INSURANCE—CAUSE OF DEATH—EXTERNAL INJURY

Insured, while in good health, ate wholesome food which he later regurgitated. Some of it lodged in his larynx and caused his death by asphyxiation. HELD: Death was the result of *external,* violent and accidental means, within the double indemnity provisions of the insurance policy. *People's Life Insurance Co.* v. *Menard,* 117 N.E.2d 376 (Ind. 1954).

Where an insurance policy provides for indemnity for injuries inflicted by external, violent and accidental means, each of these elements must be specifically shown to have existed in the "accident" as it occured.[1] "Accidental means" as used in an insurance policy signifies a happening by chance and without intention or design, which happening is unforeseen, unexpected, and unusual at the time it occurs.[2]

Death caused by a means which is not natural, *i.e.,* the result of an "accident" of any kind, imports an external and violent agency as the cause, within the meaning of a double indemnity clause limiting recovery to death from an external, violent and accidental cause.[3]

Death or disability incident to the partaking of food or drink may result either from its mechanical action, causing choking or injury to the membranes, or directly from poisoning or indirectly from disease. The majority view on the subject is to the effect that death or disability resulting from the mechanical action of food or drink amounts to an accidental means. Thus, death caused by choking on food, which, in an attempt to be swallowed, accidentally passes into the windpipe is covered by an accident insurance policy providing that the insurer's liability shall attach only where the injury is through external, violent and accidental means.[4]

The court was not disturbed, and did not labor over whether the death in the instant case was of a "violent and accidental" nature. It was recognized that the vital question was whether regurgitated food can cause an "external" injury. The decision

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[1]VANCE, INSURANCE § 258 (2d ed. 1930); Travellers' Ins. Co. v. McConkey, 127 U. S. 661 (1888); Oklahoma Nat. Life Ins. Co. v. Norton, 44 Okla. 783, 145 Pac. 1138 (1915). Also see Note: L.R.A. 1915E 695.

[2]Martin v. People's Mut. L. Ins. Co., 145 Ark. 43, 223 S.W. 389 (1920); Bohaker v. Traveler's Ins. Co., 215 Mass. 32, 102 N.E. 342 (1913); Ashley v. Agricultural L. Ins. Co., 241 Mich. 441, 217 N.W. 27 (1928).

[3]American Acci. Co. v. Reigart, 94 Ky. 547, 23 S.W. 191 (1893). Also see Note: 35 A.L.R. 737, 52 A.L.R. 374.

[4]Am. Jur. Vol. 29, Insurance § 991, p. 743. Gohlke v. Hawkeye Commercial Men's Ass'n, 198 Iowa 144, 197 N.W. 1004 (1924); American Acci. Co. v. Reigart, *supra,* note 3; Jenkins v. Hawkeye Commercial Men's Ass'n, 147 Iowa 113, 124 N.W. 199 (1910). In the case cited last, death due to swallowing a fish bone was held to be caused by violent, external and accidental means.

was justified on the principle that there is no fundamental difference between the mechanical action of food as it is taken into the body initially and after regurgitation.[5] The court had no direct authority upon which to base its opinion, this particular question being one of first impression in the law of insurance.

The dissent agreed with the majority opinion that death was the result of violent and accidental means, but was of the opinion that the evidence did not support the fact of injury and death through external means, since food returning from the stomach upon regurgitation, and lodged in the throat is yet internal.[6]

Edward L. Cook, Jr.

Workmen's Compensation—Suicide—Compensable When Caused by Mental Disorder From Work-Connected Injury

Decedent, in the course of his employment, received an accidental injury which resulted in an inguinal hernia. An operation was performed and a month later decedent committed suicide. Held: Evidence supported Workmen's Compensation Board's determination of a condition of psychosis, depressive in character, of a mental disease, and of a mental or brain derangement affecting decedent's sanity which was the natural and unavoidable result of his compensable injury and thus led to suicide. *Maricle v. Glazier*, 283 App. Div. 402, 128 N.Y.S. 2d 148 (1954).[1]

The American decisions in suicide cases under workmen's compensation acts have followed the rule as first set out in *Sponatski's Case*[2] which stated in effect that to be compensable, it must be proved that the insanity was caused by the injury and that the deceased did not realize he was causing his own death or that he acted through an uncontrollable impulse or in a delirium of frenzy without volition to cause death.[3] Suicide, of course, must be the result of some physical injury arising out of and in the course of the employment.[4] If the insanity or mental derangement causes the suicide, then there is no willful self-destruction[5] which is the only statutory exception to the right to an award of compensation.[6]

The problem of suicide in compensation cases resolves to one of proximate cause versus independent intervening cause. Under the earlier theories, it was practically

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[5]"There is no difference in principle in the mechanical action of food lodging in the wind pipe and resulting in asphyxiation after regurgitation, in the absence of infirmity of mind or body from illness or disease, and the asphyxiation brought about by the mechanical action of food taken internally at the time it is first taken into the body." People's Life Insurance Co. v. Menard, 117 N.E.2d 376 (Ind. 1954).

[6]People's Life Insurance Co. v. Menard, *supra*, note 5.

[1]Affirmed *per curiam* on appeal to New York Court of Appeals, 121 N.E. 2d 549 (1954). Judge Van Voorhis dissented, however, stating that the cause of suicide was found without evidence of any probative force to sustain the finding.

[2]220 Mass. 526, 108 N.E. 466 (1915). The deceased employee received an injury through a splash of molten lead into his eye and after suffering from a mental condition accompanied by hallucinations and delusions, committed suicide.

[3]This decision rests upon the rule established in the tort case of Daniels v. New York, New Haven & Hartford Ry., 183 Mass. 393, 67 N.E. 424 (1903). See also Note, 62 L.R.A. 751 and *Restatement, Torts*, § 455 (1934).

[4]Wilder v. Russell Library Co., 107 Conn. 56, 139 Atl. 644 (1927), seems to stand alone as an example of suicide unaccompanied by any definite physical injury.

[5]See Rushchetti's Case, 299 Mass. 426, 13 N.E. 2d 34 (1938); Barber v. Industrial Commission, 241 Wis. 462, 6 N. W. 2d 199 (1942); Jones v. Traders and General Insurance Co., 140 Tex. 599, 169 S.W. 2d 160 (1943); Konazewska v. Erie Ry., 132 N.J.L. 424, 41 A. 2d 130 (1945); Widdis v. Collingdale Millwork Co., 169 Pa. Super. 612, 84 A. 2d 259 (1951); Karen v. Department of Labor and Industries, 41 W. 2d 301, 249 P. 2d 364 (1952). See also Note, 56 A.L.R. 459 and Note, 143 A.L.R. 1227.

[6]The statutes of Connecticut, Illinois, Michigan, Montana, Nebraska, New Hampshire and Wyoming make no reference to suicide or intentional self-injury.

impossible to award compensation in suicide cases. It was said that the accident caused the insanity and the insanity caused the suicide; but that since the deceased knew that he was ending his life, he broke the chain of causation. Indeed, it was a harsh rule and was not in harmony with the legislative purpose in the passage of the laws. This has been called "a bit of narrow common law harking. . . . "[7]

The current trend seems to be that if the injury produces insanity and the insanity causes the suicide, then the suicide is compensable. This rule may be invoked even though there is a finding that the employee knew the physical consequences of his act and that there is no evidence of an uncontrollable impulse or a delirium of frenzy. England,[8] Florida,[9] Ohio[10] and New York[11] seem to follow this minority rule which is the more liberal view. The broader, more humane rule was adopted in at least one federal court of appeals when it was held that the evidence sustained a finding that the employee's suicide resulted from insanity caused by shock in an explosion received in the course of the employment and hence was not willful within the statutory exception from compensability.[12]

In the instant case, it is submitted that the result reached is in accord with the liberal interpretation given to the workmen's compensation laws which are "intended to redress the incidence of economic loss inevitable in industry."[13] It is apparent the New York court is following the more liberal view in holding that the record sustains the board's finding of a causal connection and death by suicide as the natural and unavoidable result of the injuries sustained by decedent. There is no mention of "irresistible impulse" or "delirium of frenzy" or "willful volition to take one's life."[14] It would appear under the broader minority view that if the reason the employee knowingly decides to kill himself is the pain and despair resulting from the previous injury, and if the will itself is deranged and disordered as consequences of the injury, then there is a direct line of causation. In the instant case, it seems that the judge found enough evidence, however, to satisfy even the majority rule.

"The future trend overwhelmingly will be to compensate for suicide which stems from insanity or mental derangement consequent upon industrial injury, without the need of indulging in either factual, conjectural or false findings of uncontrollable impulse or delirium of frenzy or knowledge of the physical consequences of the suicidal act."[15]

James E. Hardin

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[7]*Horovitz, Injury and Death Under Workmen's Compensation Laws* 136 (1st ed. 1944). *See* also the dissent of Fowler, J., in Barber v. Burrell Engineering Co., 241 Wis. 462, 6 N.W. 2d 199 (1942).

[8]Marriott v. Malty Main Colliery Co., 13 B.W.C.C. 353 (1921); Graham v. Christie, 10 B.W.C.C. (Scot.) 486 (1916).

[9]Whitehead v. Keene Rooting Co., 43 So. 2d 464 (Fla. 1949).

[10]Burnett v. Industrial Commission, 93 N.E. 2d 41 (Ohio App. 1949). The judge allowed the jury to pass upon whether the suicide was an involuntary act wholly without volition, and the jury so found.

[11]Delinousha v. National Biscuit Co., 248 N.Y. 93, 161 N.E. 431 (1928); Stapleton v. Keenan, 268 N.Y.S. 974, 193 N.E. 305 (1934); Puskarowitz v. A. & M. Kramer, 275 App. Div. 875, 88 N.Y.S. 2d 381 (1949), *aff'd* 300 N.Y. 637, 90 N.E. 2d 494 (1950); Wessells v. Lockport Cotton Bathing Co., 275 App. Div. 733, 87 N.Y.S. 2d 186 (1949); Blau v. Goldshare Restaurant, 278 App. Div. 595, 102 N.Y.S. 2d 84 (1951).

[12]Voris v. Texas Employers Ins. Association, 190 F. 2d 929 (5th Cir. 1951). The findings were sufficient to sustain liability under either the claim of the employer, which was the old rule, or under the new rule which was supported by the employee. The Delinousha case, *supra* note 11, was cited with favor.

[13]Delinousha v. National Biscuit Co., *supra* note 11.

[14]Thus, it seems that this would rebut the objection in the dissent. See note 1 *supra*.

[15]8 N.A.C.C.A. 54 (1951).

CRIMINAL LAW—NEW TESTS OF CRIMINAL RESPONSIBILITY

The Circuit Court of Appeals for the District of Columbia in a recent decision rejected the "right and wrong" and "irresistible impulse" tests of criminal responsibility as inadequate. The following test was adopted: an accused is criminally responsible if his unlawful act was the product of mental disease or mental defect. The court defined "disease" as a condition which is considered capable of either improving or deteriorating, and "defect" as a condition which is not considered capable of either improving or deteriorating. The new test enables the jury to decide the question of criminal responsibility on expert medical testimony rather than on outmoded legal definitions of insanity. *Durham v. United States,* 214 F.2d 862 (1954).

Since 1843 the test used solely in England and in the majority of American jurisdictions[1] to determine whether an accused is mentally responsible for his acts is the one expressed in the following quotation from *M'Naugten's Case*: " . . . to establish a defense on the ground of insanity, it must be proved that, at the time of the committing of the act, the party accused was laboring under such a defect of reason, from disease of the mind, as not to know the nature and quality of the act he was doing; or, if he did know it, that he did not know he was doing what was wrong."[2] From that same case another legal test arose when the judges, in answer to questions put to them by the House of Lords, stated in substance that an accused who is suffering from partial delusion is responsible when he commits an act under a delusion if he would be so responsible should the acts which he supposes to exist be real.[3] The effect of this doctrine is that partial insanity is recognized, but the insane defendant is required to use the reasoning of a sane person while committing the act.

In 1844 the Massachusetts Court in *Commonwealth v. Rogers* suggested another popular legal test for criminal responsibility when it said " . . . the question will be, whether the disease overwhelmed the reason, conscience, and judgment, and whether the prisoner, in committing the homicide, acted from an irresistible and uncontrollable impulse. . . ."[4] Although seventeen states have accepted the irresistible impulse as a defense, most of the remaining states, including Mississippi, have rejected it.[5] In 1879 the Mississippi Supreme Court in *Cunningham v. State* referring to the irresistible impulse test rejected it saying: "The possibility of the existence of such mental condition is too doubtful, the theory is too problematical and too incapable of a practical solution, to afford a safe basis of legal ajudication."[6] In that same case the court said that the accountability of the accused rests on the right and wrong test; and if an irresistible impulse springs from a disease and overwhelms the reason, judgment, and conscience of the accused, he is not punishable *if* he cannot distinguish between right and wrong at the time of the act.

As early as 1869 in New Hampshire it was recognized that the question of insanity should not be the subject of legal definition but of fact for the jury to determine.[7] Two years later *State v. Jones,*[8] affirming, said that when the defense of in

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[1]Weihofen, Insanity as a Defense in Criminal Law 15 (1933).

[2]8 Eng Rep 718, 722.

[3]*Id.* at 723.

[4]48 Mass. 500.

[5]Weihofen, *op. cit. supra* note 1, at 16. Jurisdictions adopting this test are Alabama, Arkansas, Colorado, Connecticut, Delaware, District of Columbia, Illinois, Indiana, Kentucky, Louisiana, Massachusetts, Michigan, Montana, New Mexico, Ohio, Virginia, Vermont, and Wyoming.

[6]56 Miss. 269, 279. This opinion has been subsequently approved in this state by Smith v. State, 95 Miss. 786, 49 So. 945 (1909) and Eatman v. State, 169 Miss. 295, 153 So. 381 (1934).

[7]State v. Pike, 49 N.H. 399 (1869).

[8]50 N.H. 369, 399 (1871).

sanity is raised the question to be determined is whether at the time of the act the accused had mental capacity to entertain a criminal intent.

For the accused to defend himself on the ground of insanity in jurisdictions where the "right and wrong" test, and the "irresistible impulse" test are used, he must meet the legal tests which inadequately cover the field of insanity as known to the medical profession.[9] The Circuit Court of Appeals for the District of Columbia has therefore attacked the problem in a straight forward manner, leaving the question of insanity to be determined by the jury on the basis of general expert medical testimony, unfettered by complicated and confusing legal tests.

Dorothy Clower

AGENCY—BORROWED SERVANT DOCTRINE

Defendant's agent was employed to sell, handle and demonstrate the use of its explosives. He was requested by the county engineer to give advice in the use of defendant's dynamite at the county rock quarry. The agent gave full instructions, and set off the dynamite himself. The resulting blast caused damage to the plaintiffs' premises, for which they charge the defendant with negligence because of the advice of its agent. HELD: In giving the advice, which is alleged to have been the negligent act, the agent was clearly operating within the scope of his employment by defendant. *Fleming et al v. E. I. Du Pont De Nemours & Co., Inc.*, 81 S. E. 2d 529 (Ga. 1954).

In certain instances a question of law arises as to who is the principal or master at a particular time; but usually this is a question of fact for the jury to decide, basing the decision upon an application of legal principles imparted by the court.[1] A consideration of these legal principles should be of interest in analyzing this case.

An agent or servant who is in the paid employment of one person may nevertheless be, *ad hoc,* the agent or servant of another, as to a particular operation, even though the general employer has an interest in the operation.[2] When a servant of one person is loaned to another for a particular purpose, any liability arising therefrom will be considered to be the liability of the person to whom he is loaned, although the servant remains in the general employment of the lender.[3]

In order to determine whether the employee's acts are the responsibility of the general employer or of the special employer, it is necessary to determine whose work is being performed.[4] The best way in which to ascertain whose work produced the injury is to determine under whose control the servant was at the time of the injury, and who could give him orders and discharge him.[5] *Ad hoc* employment may be based only upon the surrender of complete control by the general employer for the operation performed.[6] It has also been held that the right of control, not its exercise, is the criterion.[7]

If the employee is furthering his general employer's business by the service ren-

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[9]32 Col. L. R. 933 (1932); 30 H.L.J. 535 (1917); 56 Y.L.J. 959 (1947).

[1]Ramsey v. New York Central Ry., 269 N. Y. 219, 199 N. E. 65 (1935).
[2]Wyllie v. Palmer, 137 N. Y. 248, 33 N. E. 381 (1893).
[3]Bibb Mfg. Co. v. Souther, 52 Ga. App. 722, 184 S. E. 421 (1936); Travelers Insurance Co. v. Clark, 58 Ga. App. 115, 197 S. E. 650 (1938).
[4]Standard Oil Co. v. Anderson, 212 U. S. 215 (1909).
[5]Brown v. Smith, 86 Ga. 274, 12 S. E. 411 (1890).
[6]Irwin v. Klein, 271 N. Y. 477, 3 N. E. 2d 601 (1936).
[7]Sidekum v. Animal Rescue League of Pittsburgh, 353 Penn. St. 408, 45 A. 2d 59 (1946).

dered to another, no inference of a new relation will be raised unless control has been surrendered, and there will be no inference of its surrender merely from the division of control itself.[8] In order to escape liability the general employer must relinquish full control of the employee for the time being,[9] and the burden is on the general employer to prove a complete surrender of control.[10]

In the present case one interpretation of the facts led to the confirmed opinion of the majority of this court, while another led to a nonsuit in the lower court and a vigorous dissent here. The dissent is based on the argument that the defendant did not have control over the agent's conduct in the service he was performing for the county; that the county engineer could have discharged him at any time during the operation; and that the operation itself was not within the scope of his employment by the defendant, nor a furtherance of the defendant's business. The merit in the dissenting argument shows clearly how the same facts can be construed to opposite results in a case of this kind.[11] The rules of law on this subject seem to be well defined. It is in the application of them to the particular facts that the uncertainty arises.

Harry C. Griffith

LABOR RELATIONS–STATE REGULATIONS OF LABOR UNIONS

The State of Texas enacted a statute requiring all labor union organizers operating in the state to file with the Secretary of State, before soliciting any members for his organization, a written request for an organizer's card, stating: (1) name in full; (2) labor union affiliations, if any; (3) description of credentials. Upon the filing of such application an organizer's card was to be issued by the Secretary of State to the applicant. Punishment for violation of this section results in an assessment of a $500 fine.[1] Defendant was convicted of violating the statute. Upon appeal to the Court of Criminal Appeals, defendant alleged the invalidity of the statute as in conflict with the National Labor Relations Act.[2] HELD: The statute is valid on the basis of the police power of the State, which, the Court believed, was recognized in an identical situation by the United States Supreme Court in *Thomas v. Collins*.[3] The dissent was of the opinion that the Supreme Court, in the case of *Hill v. Florida ex rel. Watson*,[4] had restricted the State's police power in this respect in a later identical situation. *Coutlakis v. State*, Tex. Cr. App., 268 S.W.2d 192 (1954).

The *Thomas* case, wherein the same Texas statute was before the Court, was decided in January of 1945. The Supreme Court reversed the lower court upon a

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[8]Charles v. Barrett, 233 N. Y. 127, 135 N. E. 199 (1922).
[9]Hodges v. Holding, 224 Okla. 327, 229 P. 2d 555 (1951).
[10]Anderson v. Abramson, 234 Iowa 792, 13 N. W. 2d 315 (1944).
[11]Where a railroad company had availed itself of the services of a flagman at a street crossing who was employed by another company, the railroad company was held liable for the flagman's negligence in the performance of such services. Denver & R. G. Ry. v. Gustofson, 21 Colo. 393, 41 Pac. 505 (1895). Also of particular interest is Benoit v. Hunt Tool Co., — La. App. —, 45 So. 2d 512 (1950) which was reversed by 219 La. 380, 53 So. 2d 137 (1951).

[1]Vernon's Ann. Civ. St., art. 5154a, sec. 5.
[2]29 U.S.C.A. Sec. 151 et seq.
[3]Thomas v. Collins, 323 U.S. 516, 65 S. Ct. 315, 89 L. Ed. 430 (1945).
[4]Hill v. Florida ex rel. Watson, 325 U.S. 538, 65 S. Ct. 1373, 89 L. Ed. 1782 (1945).

ground not material to the present note,[5] but stated explicitly that the Court was not agreed that the statute was in conflict with the National Labor Relations Act.

Five months later the Supreme Court decided the *Hill* case, and invalidated a similar section of a Florida act.[6] Under the Florida statute there were four requirements precedent to the union's right to solicit members: (1) pay $1; (2) file name of organization; (3) state location of its office; (4) state names and addresses of its officers. A violation of this statute was declared to be a misdemeanor. Under the Texas act the information required was: (1) name; (2) union affiliations; (3) description of credentials. Thus the qualifying requirements and effect of failure to comply in their practical applications are the same. In the *Hill* case, however, the Court found the Florida statute in conflict with the purpose of the National Labor Relations Act, i.e., to encourage collective bargaining, and to protect the "full freedom" of workers in the selection of bargaining representatives of their own choice.[7]

The Court further stated that it was not the duty to report, but the sanction imposed which conflicts with the National Labor Relations Act. The word, "sanction," is defined as "means of enforcement."[8] Such subjection to criminal prosecution brings about a situation inconsistent with the federally protected process of collective bargaining. For if the union or its representatives acted as bargaining agent without making the required reports, they would be liable under the misdemeanor section of the act. "Such an obstacle to collective bargaining cannot be created consistently with the Federal Act."[9]

From the opinion of the *Hill* case, and from the history of the shrinkage of the states' power by congressional action and judicial interpretation, the conclusion is almost inevitable that the Texas statute, or any other similar state statute, will be invalidated by the United States Supreme Court.

James C. Pittman, Jr.

TORTS—WRONGFUL DEATH OF UNBORN CHILD

Mrs. Rainey, her husband, and four children, brought this action for the wrongful death of her unborn child under the wrongful death statute[1] of Mississippi, such being predicated on the negligence of the appellee, Dr. Horn, in trying to force the birth of the child before Mrs. Rainey was in labor. Dr. Horn, at the request of Mr. Rainey, called to examine Mrs. Rainey and tried unsuccessfully to force the birth of the child. Prior to such attempts the child was alive and moving in the womb of Mrs. Rainey. After a period of excessive bleeding, Mr. Rainey requested that his wife be removed to the hospital immediately. Witnesses stated they thought Mrs. Rainey was dying, and that after the attempts by Dr. Horn to force the birth of the child, no movement on the part of the baby could be detected. Mrs. Rainey was removed to the hospital where the child was born dead four hours after her arrival. The trial resulted in a hung jury, whereupon the court entered an order of mistrial. Appellee moved the court for judgment notwithstanding the mistrial verdict, which motion was

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[5]The Supreme Court held that to enjoin the defendant from making a speech on behalf of the union, and soliciting workers to join, merely because defendant had received no license, was violation of the First Amendment.

[6]F. S. A., Sec. 481.01 et seq.

[7]29 U.S.C.A. Sec. 151.

[8]Commissioners' Court of Nolan County v. Beall, 98 Tex. 104, 81 S. W. 526 (1904).

[9]Hill v. Florida ex rel. Watson, *supra*, note 4.

[1]MISS. CODE § 1453.

sustained on the basis that appellee was entitled to a peremptory instruction, and the case was dismissed. On appeal the case was reversed and remanded. HELD: Once a child reaches the prenatal age of viability and dies before birth as a result of the negligent act of another, an action may be maintained for its death under the wrongful death statute, *Rainey v. Horn*, 72 So.2d 434 (Miss. 1954).

At the common law the child was part of the mother until birth; therefore, no action lay for prenatal injuries.[2] This is the general rule today, but it has not received universal approval. Some comparatively recent decisions, indicative of a more liberal and realistic approach to the problem, support the view that an unborn child, viable[3] and capable of existing independently of its mother when injuries are wrongfully inflicted upon it, may, after birth, maintain an action for such injuries.[4] The latest decisions on the subject represent a definite departure from the rigidity of the more orthodox view, and may be indicative of a trend toward the extension of the doctrine that an unborn child will be regarded in esse when beneficial to the child. Such decisions seem limited by implication to instances wherein the injured child was viable and capable of independent existence when the injuries were sustained and the child survived.[5]

The instant case does not involve injuries but the wrongful death of the unborn child. Generally speaking it is essential to the maintenance of an action for death by wrongful act or default that the act or default be of such character as would have supported an action by the decesased for his injuries if he had survived. This limitation on the right of action is created by express provisions of Lord Campbell's Act[6] and by most of the statutes in the United States based thereon. If the deceased never had a cause of action, none accrues under a wrongful death statute.[7] In the absence of statute, the child has no right of action for his injuries prior to birth. Further, it is obvious that the deceased must have been living or alive in contemplation of law at the time the negligent injuries were inflicted for the action to be allowed.

The child in the instant case was born dead, so the issue was whether or not the child was recognized in law as in existence as a person. An unborn child is recognized as in existence in property law, and since the child is so recognized, the minority of the courts at present have extended this principle to the law of torts.[8]

"Life," says Blackstone, "begins in contemplation of law as soon as an infant is able to stir in the mother's womb."[9] If life begins as soon as the infant is able to stir in the womb of the mother, and every legitimate infant *en ventre sa mere*[10] is to be deemed to be born for all purposes beneficial to the child, why should it be supposed the common law would have denied to an infant born alive the right of action for

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[2]Alliare v. St. Luke's Hospital, 184 Ill. 359, 56 N.E. 638 (1900). See dissent of Justice Boggs.

[3]"Viable" means livable, having the appearance of being able to live. Wehrman v. Farmers & Merchants' Savings Bank of Durant, 221 Iowa 249, 259 N.W. 564 (1935).

[4]Bonbrest v. Kotz, 65 F. Supp. 138 (D.C. 1946); Cooper v. Blanck, 39 So.2d 352 (La. App. 1923); Williams v. Marion Rapid Transit, Inc., 152 Ohio St. 114, 87 N.E.2d 334 (1949). The holding in a Canadian case, Montreal Tramways v. Leville, Can. S.C. 456, 4 D.R.R. 337 (1933), appears broad enough to permit recovery for prenatal injuries sustained at *any* prenatal stage. Such result would seem desirable, although no American decision has yet traversed this legal territory.

[5]Boubrest v. Kotz, *supra*, note 4; Cooper v. Blanck, *supra*, note 4; Williams v. Marion Rapid Transit, Inc., *supra*, note 4.

[6]9 & 10 Vict. c. 93 (1846).

[7]MISS. CODE § 1453.

[8]*Supra*, note 4.

[9]1 BL. COMM. 129.

[10]In its mother's womb, a term descriptive of an unborn child. For some purposes the law regards an infant *en ventre* as in being. 1 BL. COMM. 130.

his prenatal injuries? On the same basis, there is no good reason to deny the right of action for the death of such infant to the parent, whether the child be born alive or dead. The court allowed recovery in this case because the child was viable, the decision being expressly limited to a fetus at that stage of development.

It is submitted that the court could have reached the same result under the wrongful death act and the provisions of the Mississippi Constitution. Section 24 of the Mississippi Constitution affords a remedy to every "person" for injury done him in his person.[11] The minority of the jurisdictions hold that a child *en ventre sa mere* is a child in being under the purview of statutes containing the word "person." Therefore, the child in this case could have been considered a "person," and injuries wrongfully inflicted upon an unborn child capable of existing independently of the mother are injuries done him "in his person" within the meaning of Section 24 of the Mississippi Constitution.[12] If subsequent to his birth he might bring the action for such injuries so inflicted, this right accrues to his parents under the wrongful death statute of Mississippi. To announce that as a matter of law the infant is a part of the mother until birth and has no existence in law until that time would deprive the infant of the right conferred by the constitution upon all persons. Such is simply a time-worn fiction not founded on fact and within common knowledge untrue and unjustified.[13]

The instant case and a Minnesota case[14] decided in 1949 are the only two American cases that have allowed recovery for the death of an unborn infant in a tort action. The trend is definitely changing as witnessed by the change in the philosophy undelying the right of action by the infant for his prenatal injuries upon his survival.

George D. Warner, Jr.

DAMAGES—COMPENSATION FOR DEATH OF CHILD UNDER WRONGFUL DEATH STATUTE

An employee of Sandifer Oil Company, pumping gasoline from a truck into the storage tanks of a local filling station operator, negligently allowed the tank to overflow. An explosion followed, and a fourteen year old girl, walking along a nearby road was fatally burned, dying after 91½ hours of intense pain and suffering. A suit was brought against the Oil Company under the Wrongful Death Statute and the jury awarded $90,000 damages. Sandifer Oil Company appealed, relying, among other things, particularly on the excessiveness of damages. HELD: The damages were not excessive and judgment was affirmed. *Sandifer Oil Co., Inc. v. Dew,* 71 So.2d 752 (Miss. 1954).

The elements of damages considered in the case were: (1) physical and mental pain and suffering, (2) loss of society and companionship, (3) value of loss of services, and (4) punitive damages. While no previous case was referred to which in itself supported such an amount, various awards in separate suits, each being considered for one of the above mentioned elements of damage, furnished the basis on which to affirm the amount.

The court began on the sound principle that the determination of the amount of damages to be awarded is a matter for the jury and should not be disturbed by the court unless it can be shown that the jury were influenced by passion, prejudice, or

[11]MISS. CONST. ART. 3, § 24 states: ". . . and every person for an injury done him in his lands, goods, person, or reputation, shall have remedy by due process of law . . . ."

[12]Compare OHIO CONST. Art. 1 § 16, which is identical to MISS. CONST. Art 3 § 24, *supra,* note 11. Reasoning the same as here was used in the Williams case, *supra,* note 4.

[13]Williams v. Marion Rapid Transit, Inc., *supra,* note 4.

[14]Verkennes v. Corniea, 229 Minn. 365, 38 N.W.2d 838 (1949).

corruption.[1] Using a case[2] allowing $5,000 damages for pain and suffering over a six hour period, the court considered the difference in the length of time to compute adequate damages for suffering 91½ hours in the present case. A 1919 case[3] allowing $16,400 damages for loss of companionship and society was cited, and after a comparison between money value at that time and now, the court declared that $35,000 would not be excessive damages on that element in this case. Prospective losses to the family as a result of the death were also considered as an element in building up damages. Finally a case involving a $1,500 judgment[4] was used to show that punitive damages could be twice the amount allowed for other elements of damage. Thus by applying smaller judgments on various elements to the present case, a sound foundation for upholding such a large amount was built.

One element not considered was the value of the life to the child. Once held to be an element of damage in Mississippi,[5] this doctrine was first modified,[6] then disapproved,[7] and finally reinstated, at least to the extent of allowing some recovery on the life, with the amount of valuation left to the discretion of the jury.[8] Today then, the value of the life to the deceased should be considered as an element of damage in wrongful death cases.[9]

The affirmance in the instant case is a favored step in placing awards for damages in Mississippi in line with those in other jurisdictions. In New York a $165,000 verdict on a death claim was allowed.[10] Verdicts for $100,000 have been upheld in Ohio[11] and in California.[12] Federal courts have also sustained such verdicts.[13] Similarly high verdicts have been allowed in injury cases, one in Florida for $260,000 for a crushed pelvis.[14] Perhaps the principal case will provide the cornerstone on which to build and encourage judicial affirmance of jury verdicts of adequate amounts in Mississippi for injuries and wrongful deaths.

Irby Turner, Jr.

Libel — Publishing that a White Woman is a Negro is Libelous Per Se

Defendant newspaper published an account of an automobile collision, in which plaintiff, a white woman, was driving one of the cars. In the article she was described, by mistake, as a Negro woman traveling in the company of two Negro men. The men were actually white. Plaintiff sued defendant for damages, alleging that the

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[1]Mississippi Central Railroad Company v. Hardy, 88 Miss. 732, 41 So.505 (1906); Louisville & N.R. So. v. Whisenant, 214 Miss. 421, 58 So.2d 908 (1952); Teche Lines, Inc. v. Pope, 175 Miss. 393, 166 So. 539 (1936).

[2]Belzoni Hardwood Co. v. Cinquimani, 137 Miss. 72, 102 So. 470 (1924).

[3]Gulf and Ship Island R.R. Co. v. Boone, 129 Miss. 632, 82 So. 335 (1919).

[4]Tri-State Transit Co. of Louisiana v. Worley, 197 Miss. 663, 20 So.2d 477 (1945).

[5]Cumberland Telephone and Telegraph Co. v. Anderson, 89 Miss. 732, 41 So. 263 (1906); Mississipi Oil Company v. Smith, 95 Miss. 533, 48 So. 735 (1909).

[6]New Deemer Mfg. Co. v. Alexander, 122 Miss. 859, 85 So. 104 (1920).

[7]Natchez Coca Cola Bottling Co. v. Watson, 160 Miss. 173, 133 So. 677 (1931). Value of life expectancy to the decedent was not allowed as an element of damage.

[8]Gordon v. Lee, 203 Miss. 21, 43 So.2d 665 (1949).

[9]Barnett, *The Adequate Award in Mississippi,* 25 Miss. L.J. 244, 248 (1954).

[10]Pike v. Consolidated Edison Co., 303 N.Y. 1, 99 N.E. 2d 885 (1951).

[11]Smith v. Pennsylvania Railway Co., 99 N.E. 2d 501 (Ohio App. 1950).

[12]Gall v. Union Ice Company, 108 Cal. App.2d 303, 239 P.2d 48 (1951).

[13]Naylor v. Isthmian Steam Ship Co., 187 F.2d 538 (2nd Cir. 1951)—$115,000; De Vito v. United Air Lines, 98 F. Supp. 88 (E.D. N.Y. 1951)—$300,000.

[14]Florida Power and Light Co. v. Watson, 50 So.2d 543 (Fla. 1951). For further verdicts of like amount see Barnett, *supra* note 9, at 250.

article was libelous. HELD: In this state, to assert in print that a white woman is a Negro is libelous per se. *The Natchez Times Publishing Co. v. Dunigan,* 72 So. 2d 681 (Miss. 1954).

In the subject case the Mississippi Supreme Court used the definition of libel per se as set out in an earlier Mississippi case in these words: "At common law any written or printed language which tends to injure one's reputation, and thereby expose him to public hatred, contempt or ridicule, degrade him in society, lessen him in public esteem or lower him in the confidence of the community is actionable per se."[1] The court concluded in the instant case that "the effect in this state of publishing that a white woman is a Negro is embraced by that definition."[2] It is interesting to note that the present case marks the first decision by the Mississippi Supreme Court that to write of a white woman that she is a Negro is libelous per se. In a previous decision in the same court, in which the defendant had said to another that plaintiff "had Negro blood in him," the words were said to be within the state's Actionable Words Statute.[3] The previous decision involved an action for slander, whereas in the present case the action was for libel.

The great weight of authority in libel cases involving charges that the plaintiff is of African origin is that such an imputation is actionable per se.[4] The unanimous opinion in the principal case also noted that such was the rule in South Carolina, Louisiana, Kentucky, Tennessee, and Oklahoma, where social customs are very similar to those of the state of Mississippi.[5] The rule making such charges, when false, libelous per se has been applied even where the charge was made by mistake.[6] Such was the situation in the principal case.

By the decisions of early cases in the United States, calling a man a mulatto was held actionable per se, because if true the party would generally be deprived of all civil rights and would be liable to be tried in all cases under the Negro Act, without the privilege of a trial by jury.[7] Southern courts have continued to hold that such charges are actionable per se, even after the enactment of the Thirteenth, Fourteenth, and Fifteenth Amendments to the Federal Constitution.[8] The approach in these cases has been that these amendments in no way affect the social relations between the white and the colored races.

To call a white person a Negro or mulatto generally is not actionable per se, as slander.[9] However, under the social habits, customs, and prejudices prevailing in some states it has been held that to call a white person a Negro or mulatto is action-

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[1]Conrov v. Breland, 186 Miss. 787, 189 So. 814 (1939).

[2]The Natchez Times Pub. Co. v. Dunigan, 72 So. 2d 681, 684 (Miss. 1954).

[3]Scott v. Peebles, 2 Sm. & M. 546 (Miss. 1844); MISS. CODE § 1059 (1942).

[4]Stultz v. Cousins, 342 Fed. 794 (6th Cir. 1917); Morris v. State, 109 Ark. 530. 160 S.W. 387 (1913); Upton v. Times-Democrat Pub. Co., 104 La. 141, 28 So. 970 (1900); Collins v. Oklahoma State Hospital, 67 Okla. 229, 184 P. 946 (1916); Flood v. News & Courier Co., 71 S.C. 112, 50 S.E. 537 (1905); Stephenson, *Race Distinctions in American Law,* 43 Am. L. Rev. 29 (1909).

[5]Cases cited Note 4, *supra.*

[6]Upton v. Times-Democrat Pub. Co., *supra* note 3. (Publishing a telegraphic dispatch concerning a white man which as originally written referred to him as a "cultured gentleman" but was incorrectly transmitted by the telegraph company as "colored gentleman" and was later changed by a newspaper editor to Negro was held libelous per se).

[7]King v. Wood, 10 S.C.L. (1 Nott & M'C) 184 (1818).

[8]May v. Shreveport Traction Co., 127 La. 420, 53 So. 671 (1910), (Wherein conductor on street car indicated that white person should sit in section reserved for Negroes); Spencer v. Looney, 116 Va. 767, 82 S.E. 745 (1914).

[9]McDowell v. Bowles, 53 N.C. (8 Jones, L.) 184 (1860); for other cases in point, see 50 A.L.R. 1417. Williams v. Riddle, 145 Ky. 459, 140 S.W. 661 (1911), (Court emphasized that the action was one for slander and not one for libel, and recognized that in actions of the latter class the rule is stronger against the defendant).

able.[10] Some northern states have adopted the view that such charges are not actionable,[11] even to the extent of holding that such a charge in a newspaper article does not constitute libel per se.[12] In England it has been held that to write of another than he is "man Friday," the innuendo that the person of whom the words were written was of African origin, was not defamatory.[13]

An alleged utterance that plaintiff is a half-breed Mexican is not such a charge as subjects the person of whom it is spoken to public ridicule, ignominy, or disgrace, and is not, therefore actionable per se.[14] That case appears to be the only one in which the alleged defamatory imputation was other than the injured party was of African origin.[15]

In view of the existing social customs and practices of the state and area, it is submitted that Mississippi and the other southern states will probably continue to follow the rule as stated in the principal case.

W. Swan Yerger

CONSTITUTIONAL LAW — DEPORTATION OF FORMER COMMUNIST ALIENS

Petitioner, a thirty year resident of the United States, was ordered deported under the Internal Security Act of 1950[1] because he had been since entry, but before passage of that Act, a member of the Communist Party. HELD: Even though he may have joined the Communist Party without knowledge of its advocacy of violence, he was deportable as a party member. *Galvan v. Press*, 74 S.Ct. 737 (1954).

That Congress has the power to exclude[2] and deport[3] is not questioned. The alien seeking entrance has no right of entry,[4] only a privilege to be exercised upon such terms and procedure as the United States shall provide. Whatever Congress provides is due process to the alien seeking admittance.[5] On first entry he has no constitutional right to notice and hearing on the question of whether or not he is an excludable person.[6]

The condition is somewhat changed, however, as to the alien who has been admitted and becomes a resident. Such aliens are "persons" within the meaning of the due process clauses of the Fifth and Fourteenth Amendments[7] and, in criminal proceedings are also entitled to the other protections of the Fifth and Sixth Amendments.[8] In deportation actions the procedural due process to which resident aliens are entitled

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[10]Morris v. State, 109 Ark. 530, 160 S.W. 387 (1913); Spotorno v. Fourichon, 40 La. Ann. 425, 4 So. 71 (1888); Mopsikov v. Cook, 122 Va. 579, 95 S.E. 426 (1918).

[11]Wright v. F. W. Woolworth Co., 281 Ill. App. 495 (1935); Barret v. Jarvis, Tapp. 244 (Ohio 1818).

[12]Mitchell v. Tribune Co., 343 Ill. App. 446, 99 N.E. 2d 397 (1951).

[13]Forbes v. King, 1 Dowe. P.C. 672 (Eng. 1833); Hoare v. Silverlock, 12 Q.B. 626 Eng. Reprint, 1004 (1848).

[14]Davis v. Meyer, 115 Neb. 251, 212 N.W. 435 (1927).

[15]50 A.L.R. 1413 (1927).

[1]U.S. CODE AND CONG'L SERV., 1950 pp. 1001-1003.

[2]Chase Chan Ping v. United States, 130 U.S. 581 (1889).

[3]Ng Fong Ho v. White, 259 U.S. 276 (1921); Bugajewitz v. Adams, 228 U.S. 585 (1912); Fong Yue Ting v. United States, 149 U.S. 698 (1893).

[4]Nishimura Ekiu v. United States, 142 U.S. 651 (1892).

[5]United States *ex rel.* Knauff v. Shaughnessy, 338 U.S. 537 (1950); United States *ex rel.* Volpe v. Smith, 289 U.S. 422 (1932).

[6]Kwong Hai Chew v. Colding, 344 U.S. 590 (1953).

[7]Yick Wo v. Hopkins, 118 U.S. 356 (1886).

[8]Wong Wing v. United States, 163 U.S. 228 (1895).

requires notice of the charge against them and the right to a hearing. Such hearing need not be before a branch of the judiciary; an administrative tribunal will be sufficient.[9] The administrative decision is considered final and no court in the absence of an express grant of authority may review the deportation order unless it can be shown that the hearing was unfair or the order was unsupported by the evidence.[10] The statutes concerning alien exclusion and deportation proceedings[11] provide that the administrative decision shall be final. However, the cases in this field show that the Court has been able to create or deny reviewability of such administrative decisions though the statutes remained the same. Judical review establishing administrative finality is limited by the Court perhaps for these reasons: "The courts do not care to interfere with the government's action in its capaciyt as a sovereign; the political branches of the government have the predominant role in protecting the nation's security; resident aliens have no legally enforcible rights to restrain their residence as against legislative judgments; deportation is not criminal so constitutional guaranties do not apply."[12]

The resident alien is not assured, however, of the right of being released on bail. *Carlson v. Landon* affirmed the detention pending deportation of certain present Communist Party members without bail on the ground that the Eighth Amendment is applicable only to bailable criminal offenses, whereas, deportation is a civil proceeding. Similarly, the *ex post facto* clause, applying only to crimes, is no protection to the alien against retroactive deportation statutes.[14] He has no freedom from exclusion as a security risk if he once voluntarily leaves the United States and subsequently seeks readmission without possessing the proper papers.[15]

That Congress may deport those who advocate the overthrow of the government by force,[16] or even those merely affiliated with such groups,[17] is well established. The extreme hardship arises from Congress' unchecked power to declare that prior membership, though voluntarily severed, is ground for deportation.[18] It has been suggested that the preservation of internal security justifies such shrinkage of the protection of substantive and procedural due process. The findings of the Congressional committee that reported on the Internal Security Act[19] are that Communism is a real menace to our Government and that belief in it must be eliminated at any cost. However, apparently the Court thinks that present citizen Communist Party officials are less dangerous to internal security than are resident alien Party members.[20] "But the astounding doctrine of *Carlson v. Landon* can be blamed only on the hysteria of the cold war."[21] The harsh statutory treatment has come perhaps from the fact that the aliens as a group have no political power. Thought not articulated, an element behind past decisions on deportation probably is the feeling that aliens should be allowed

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[9]Kwong Hai Chew v. Colding, 344 U.S. 590 (1953).

[10]Low Wah Suey v. Backus, 225 U.S. 460 (1911); Yantaya v. Fisher, 189 U.S. 86 (1902).

[11]26 STAT. 1084, 1085 (1891); 39 STAT. 874, 890 (1917).

[12]PRICHETT, CIVIL LIBERTIES AND THE VINSON COURT 108.

[13]342 U.S. 524 (1952).

[14]Harisiades v. Shaughnessy, 342 U.S. 580 (1952); Latva v. Nicolls, 106 F. Supp. 658 (Mass., 1952).

[15]Shaughnessy v. United States *ex rel.* Mezei, 345 U.S. 206 (1953).

[16]Sormuner v. Nagle, 59 F.2d 398 (9th Cir. 1932).

[17]Kjar v. Doak, 61 F.2d 566 (7th Cir. 1932).

[18]Harisiades v. Shaughnessy, 342 U.S. 580 (1952); Martinez v. Neely, 197 F.2d 462 (7th Cir. 1952).

1950 U.S.C.A. § 781 (1952).

[20]Compare Stack v. Boyle, 342 U.S. 1 (1951) allowing bail for citizen Communist officials with Carlson v. Landon, 342 U.S. 524 (1952) denying bail for alien Communist members.

[21]PRICHETT, *op. cit. supra.*, at 113.

limited consideration since they have enjoyed the benefits of living here without assuming the responsibilities of citizenship.

The results of the increasingly harsh deportation doctrine of the United States probably will never be determined, but it has been estimated that in 1951, the first year after the passage of the Internal Security Act of 1950, there were 13,544 persons deported while 673,169 left voluntarily upon threat of deportation proceedings.[22] What are the possible remedies for alleviating seeming injustices in the field of deportation? Congress could pass a law requiring aliens to begin naturalization proceedings early in their residence here. Even that would not protect them from exclusion if they happened to leave the country for a while and seek reentry.[23] Perhaps the United States Supreme Court through interpretation could (1) broaden substantive due process by limiting Congress' power over long time resident aliens who are not now members of the Communist Party and who have shown in no other way that they foster the overthrow of the government through violence and (2) extend procedural due process by allowing all the protections given aliens in criminal cases to apply to deportation proceedings.

Mary Libby Bickerstaff

Labor Law—Discharge For Cause

A labor union, representing 10 television technicians who had been discharged by their employer because they sponsored and distributed handbills severely attacking the quality of the employer's television programs, brought this action for their reinstatement.[1] The employees claimed that their action was a right guaranteed by Section 7 of the National Labor Relations Act[2] and hence their dismissal constituted an "unfair labor practice" on the part of the employer.[3] The employer contended that since the employees' vitriolic attack on the quality of his programs made no reference to unions, to a labor controversy, or to collective bargaining, that the employees' acts were not protected and hence they could be dischaged. Held: The employer had committed no unfair labor practice because the action of the employees amounted to disloyalty and hence their discharge was for cause. *National Labor Relations Board v. Local Union 1229, International Brotherhood of Electrical Workers,* 74 Sup. Ct. 172 (1953).

In 1935, Congress, seeking to diminish the causes of labor disputes burdening or

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[22]Ballitt, *Deportation as a Denial of Substantive Due Process,* 28 Wash. L. Rev. 205, note 2 (1953).

[23]United States *ex rel.* Allcorn v. District Director of Immigration and Naturalization of Port of N.Y., 111 F. Supp. 6 (S.D.N.Y., 1953).

[1]The handbills referred to the employer's television programs in derogatory terms such as, "Is Charlotte a second-class city? You might think so from the kind of television programs being presented by the Jefferson Standard Broadcasting Co. over WBTV. Have you seen one of their television programs lately? Did you know that all the programs presented over WBTV are on film and may be from one day to five years old. . . ?"

[2]Section 7 states, "Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other *concerted activities* for the purpose of collective bargaining or other mutual aid or protection." (emphasis supplied) 49 Stat. 452 (1935), 29 U.S.C. § 157 (1946).

[3]Sections 8 (a) and 8 (a) (1) state, "It shall be an unfair labor practice for an employer—to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in Section 7." 49 Stat. 452 (1935), U.S.C. § 158 (1946).

obstructing commerce, passed the National Labor Relations Act (Wagner Act).[4] This Act sought to diminish such disputes by defining the rights of employees,[5] and also stipulating that acts of employers inconsistent with these protected rights of employees would be "unfair labor practices."[6] Since the Wagner Act said that employees could engage in "concerted activities," the courts sought to define these "concerted activities" and to determine which of them were protected under the guarantee of Section 7.

The phrase "concerted activities" was interpreted most broadly during the early administration of the Wagner Act. It was not necessary to show that the employees were a majority[7] or that they were acting in behalf of a labor union.[8] By availing themselves of Section 7 the labor unions sought to obtain judicial sanction for all kinds of diverse labor practices in which the employees participated while engaged in a labor controversy.

The courts soon manifested their lack of intent to so sanction all union activities under the guise of protected "concerted activities," and since 1935 many courts have refused to protect certain activities.[9] Thus it became possible for an employer to discharge an employee without being guilty of an "unfair labor practice," if he could show that the actions of the employees were not protected under Section 7. The courts said, in effect, that if the employees were engaged in "unprotected activities" their employer had "reason" or "cause" to discharge them and the N.L.R.B. could not effect their reinstatement. The courts found numerous "unprotected activities" and consequently there arose a body of judicial "causes for discharge," such as insubordination, disobedience, and disloyalty.[10]

Congress, when it passed the Taft-Hartley Act, took cognizance of these "unprotected acts" of employees, or judicial "causes for discharge" and gave legislative approval by an amendment to Section 10 (c) of the National Labor Relations Act.[11] By this amendment Congress specifically said that an employee could be discharged for "cause."[12] Thus, since 1947 the courts have had the task of ascertaining what constitutes "cause." Certainly all the "unprotected activities" under Section 7 constitute "cause" for discharge, but the courts have not limited the Section 10 (c) "cause" to apply only to those "unprotected activities" under Section 7. Without categorizing "cause" the courts have simply said that an employer may discharge an employee for any cause or no cause and the N.L.R.B. can do nothing about it so long as the discharge is not for a reason limited by the Act.[13] One court summarized by saying,

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[4] 49 STAT. 449 (1935), 29 U.S.C. §§ 151 *et seq.* (1946).

[5] See note 2 *supra.*

[6] See note 3 *supra.*

[7] Firth Carpet Co. v. N.L.R.B., 129 F.2d 633 (2d Cir. 1942); Olin Industries, Inc., 86 N.L.R.B. 203 (1949); Agar Packing & Provision Corp., 81 N.L.R.B. 1262 (1949).

[8] N.L.R.B. v Kennametal, Inc., 182 F.2d 817 (3d Cir. 1950); N.L.R.B. v. Phoenix Mutual Life Ins. Co., 167 F2d 983 (7th Cir. 1948); N.L.R.B. v. Tovrea Packing Co., 111 F.2d 626 (9th Cir. 1940).

[9] See U.S. Steel Co. v. N.L.R.B., 196 F.2d 459 (7th Cir. 1952) (discharge of supervisory employees of steel plant who refused to assist employer in maintaining and protecting steel plant from imminent damage and distruction during strike period, sustained); N.L.R.B. v. Draper Corp., 145 F.2d 199 (4th Cir. 1944) (wildcat strike unprotected); Southern S.S. Co. v. N.L.R.B., 316 U.S. 31 (1942) (discharge of seamen for disobedience on shipboard while away from home port, sustained).

[10] *Ibid.*

[11] 49 STAT. 449 (1935), 29 U.S.C. §§ 151 *et seq.* (1946), as amended, 61 STAT. 136 (1947), 29 U.S.C. §§ 141 *et seq.* (Supp. 1947).

[12] Section 10 (c) states, " . . . No order of the Board shall require the reinstatement of any individual as an employee who has been suspended or discharged, or the payment to him of any back pay, if such individual was suspended or discharged for *cause.* . . . " (emphasis supplied) 61 STAT. 146, 147 (1947), BT U.S.C. § 160 (c) (Supp. 1947.)

[13] Magnolia Petroleum Co. v. N.L.R.B., 200 F.2d 148 (5th Cir. 1952); Cusano v. N.L.R.B., 190 F.2d 898 (3rd Cir 1951); N.L.R.B. v. Electric City Dyeing Co., 178 F.2d 980 (3rd Cir. 1950).

" 'cause' should be such as a fair minded person may act on, and that if discharge is not arbitrarily taken with a purpose as an excuse to avoid the National Labor Relations Act it is based on sufficient cause."[14]

Hence it would seem that "cause" under Section 10 (c) not only includes all "unprotected activities" under Section 7 but is an extension thereon. Do we now have two grounds for discharge, one under Section 7 and one under Section 10 (c), or does Section 10 (c) completely replace those judicially found "unprotected activities" under Section 7? The instant case, by inference, answers that question because the case was decided on the basis of Section 7 by both the N.L.R.B. and the United States Court of Appeals,[15] but the opinion of the United States Supreme Court contained few references to Section 7. The Supreme Court discussed only "cause" and based its decision on Section 10 (c) by saying that the disloyalty of the employees was sufficient to constitute "cause for discharge."

Whether 10 (c) replaces Section 7 or simply provides another ground for discharge remains to be determined by the courts but it is apparent in the instant case that Section 10 (c) greatly broadens the grounds for discharge and the court sought, of its own accord, to use it.

Ernest R. Duff

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[14]Albrecht v. N.L.R.B., 181 F.2d 652 (7th Cir. 1950).

[15]Labor Union No. 1229, International Brotherhood of Electrical Workers v. N.L.R.B., 202 F.2d 186 (D.C. Cir. 1952).

RECENT BOOKS

TRIAL TACTICS AND METHODS. By Robert E. Keeton. New York: Prentice-Hall, Inc., 1954. Pp. 438. $7.50.

An unprecedented number of books on trial technique were published this past year. Professor Keeton's *Trial Tactics and Methods* is the best of this mediocre lot, and ranks among the superior works in this general field, along with Busch, *Law and Tactics in Jury Trials* (1949), the *Trial Practice Series* of monographs published by the Practicing Law Institute (1946), and Goldstein, *Trial Technique* (1935).[1]

The coverage in *Trial Tactics and Methods* is broader and more detailed than that of most books on the subject, although there is the usual over-emphasis on automobile negligence problems and the usual neglect of problems peculiar to such important litigation areas as crimes, child custody, divorce, collection of small debts, foreclosures, and suits to quiet title. Keeton thoroughly discusses the ordinary steps in a trial from selection of a jury to closing argument, and then has lengthy chapters on Preparation for Trial, Pleadings, and Proceedings Before Trial. There are also separate chapters on *The Non-Jury Case* and *What Makes a Trial Lawyer Effective.* The book is not a digest or even a manual of formal legal doctrine. Only a few rules of court and appellate decisions are cited; and when authorities are given for statements about the law, they are usually sections of *Wigmore* or *American Jurisprudence.* The book is primarily concerned with practices for most effectively preparing and trying law suits within the framework of the law.

To a considerable extent the book involves the steps for lawyers to take or avoid in dealing with the key persons in judicial proceedings: judges, juries, and witnesses. It could properly be sub-titled "The Psychology of Proving Facts." Keeton proceeds on the realistic premise that no matter how favorable the law may be to a litigant, he will not prevail unless a judge or jury accepts his version of the facts. As is sufficient for a book written for practitioners, Keeton's conclusion on how judges, juries, and witnesses react is based on experience and hunch. No doubt, his conclusions are fairly accurate. But they raise the questions of why people respond in the trial situation as Keeton assumes they do, and whether there is any empirical method available to test the accuracy of his assumptions. A scientific study of the trial process might disclose data that not only would be helpful ot the trial practitioner, but also might suggest changes in the law of trial procedure to achieve more accurate fact finding in litigation. One such study of the jury is now under way in Chicago, aided by a large Ford Foundation grant. Its findings may substantially change the recommendations made by future books on trial tactics.

Due to the increasing difficulty that young lawyers face in acquiring trial experience, competently written books such as *Trial Tactics and Methods* can fill a major educational need. Of course, more is necessary to create a skilled trial lawyer than the mere reading of books. But if the young lawyer carefully studies books on trial technique as he prepares for trial or as he observes the court work of older lawyers, his trial ability will increase much more rapidly. Similarly, the law schools can make use of these books as supplemental readings for their students in trial practice courses. More law schools should give attention to the development of trial competence by means of trial exercises that simulate actual litigation experience. Every student should actively participate in a series of such exercises, drawing on Professor Keeton's

[1] Other recent books on trial technique are BISKIND, HOW TO PREPARE A CASE FOR TRIAL (1954); GAZAN, TRIAL TACTICS AND EXPERIENCES (1954); LAKE, HOW TO WIN LAWSUITS BEFORE JURIES (1954); STRYKER, THE ART OF ADVOCACY (1954); APPLEMAN, SUCCESSFUL JURY TRIALS (1952); FRICKE, PLANNING AND TRYING CASES (1952); CUTLER, SUCCESSFUL TRIAL TACTICS (1949); and SCHWEITZER, TRIAL GUIDE (1948).

book or some comparable written materials as background information. Until the legal teaching profession recognizes its obligation in this regard, the number of lawyers qualified to try contested law suits will continue to decline.

Because of its wealth of detail, *Trial Tactics and Methods* should be of value to the experienced trial lawyer as well as the novice. Any lawyer, no matter how many cases he has tried, could profit from reading this book. Some of Keeton's suggestions, of which these are samples, might prove new to many experienced trial men or lead them to reconsider the desirability of practices they have been following. Jury arguments are usually too long from the standpoint of jurors. An unfavorable witness should generally be asked some questions on cross-examination so that the jury will not get the impression that the cross-examiner acquiesces in such testimony. A federal court is the best forum in a diversity case, if the strongest authority in your favor is the opinion of an intermediate state appellate court, because federal courts are more likely to follow these intermediate appellate court decisions than are state courts. After initial discussions with the client, he should be asked to prepare at his leisure a memorandum of all material facts that occur to him during the next several days. A motion to exclude harmful and objectionable evidence should be made out of the presence of the jury and in advance of its offer if it seems probable that the opposite side plans to offer such evidence. Instructions on damages are generally more favorable to the plaintiff if each item of damage is treated separately. Ordinarily you should not take depositions of your own witnesses unless they are likely to be unavailable at the time of trial. Where pleadings are read to the jury, they should be drafted in a simple style that will appeal to jurors and be understood by them.

Some trial technique books have been criticized for recommending unethical practices and describing the effective trial lawyer as though he were the participant in a game in which success is measured by how extensively he misleads the court and jury and by how frequently he surprises his opponent. Professor Keeton avoids censure of this sort by frequent warnings concerning unethical conduct, supported by citations to the canons of ethics. But still there is the implication running through the book that surprise, concealment, and misrepresentation are advantageous trial techniques.

Although over-all, *Trial Tactics and Methods* is an excellent work, it has some shortcomings. As has been indicated, more consideration should have been given to trial problems peculiar to cases other than automobile negligence. The book also suffers from too few examples. Hypothetical cases appear at the beginning of many sections and receive fairly complete discussion, but they are insufficient to clarify many of the generalizations. In addition, the writing style is frequently so complex and verbose as to make it difficult to follow the ideas presented. But considering the unfortunate style of most statutes, regulations, and judicial opinions, lawyers should be accustomed ot understanding difficult reading matter.

Quintin Johnstone
Professor of Law
University of Kansas

Constitutional Law, Cases and Materials. By Paul G. Kauper. New York, Prentice-Hall, Inc., 1954 pp. 1118. $9.50.

1954 was a year of plenty for teachers of constitutional law Two standard casebooks of venerable vintage—Dowling of Columbia and Dodd of Chicago (city not law school)—came out in revised fifth editions. Two new books made their debut: a two-volume work by four Harvard collaborators and the book under review by Professor Paul G. Kauper of the Michigan Law School.

Three of these casebooks follow the traditional pattern, the study approach being a topical one, with doctrinal analysis proceeding subject by subject. This is interesting in light of the flurry of experimentation in constitutional law teaching in recent years. This innovation has been a chronological development of the constitutional principles accompanied by much additional non-case material designed to put the decisions in their historical, economic an dsocial context and to give some information on individual Supreme Court justices. The Harvard book seeks to accomplish these latter two purposes within a topical framework and may therefore be said to be somewhere between the traditional and the experimental approaches.

Mr. Kauper sets forth the reasons for his own choice in his preface: "Constitutional Law is a compound of history, policy considerations, and conceptual and analytical thinking. In terms of current problems, it presents vital functional aspects. Much can be said for the historical type of treatment that gives emphasis to the shifts in judicial thinking from era to era in response to the changing context of the political, economic, an dsocial order. Of equal importance is the functional approach that lays stress on the considerations relevant in exploring important problems of our day. Certainly, neither historical development nor current problems can be ignored. But, ultimately, the important consideration is to present a body of materials that, in terms of coverage and sequence, will accomplish four ends: to sharpen the student's awareness of constitutional problems, stimulate critical thinking, create a sense of historical perspective necessary for appraising the current relevancy and worth of earlier decisions, and, in general, equip the mind a stock of ideas, concepts, and arguments relevant to the role of today's lawyer in handling constitutional problems."

Mr. Kauper's book is divided into two parts. Part I deals with governmental authority and its distribution. First the federal government is examined—the judiciary and the doctrine and practice of judicial review, then the powers of Congress, and finally the powers of the President. Then the powers of the states are taken up, principally the extent of the power to regulate or tax interstate commerce. Finally, there is an examination of the relations between federal government and states and relations between states. Part II is concerned with rights, privileges and immunities. There are, *inter alia*, chapters on citizenship, limitations on imposition of criminal liability, general considerations relating to due process and equal protection, freedom of enterprise, freedom from impairment of vested interests, freedom of expression, freedom of religion. and freedom from discrimination.

Close to 170 leading cases are included either in full or in extensive excerpts. Practically all of the cases are followed by notes in which related cases are discussed. Many topics not represented by cases are summarized in special notes by the editor. Interspersed throughout the book are excellent bibliographical references. Mr. Kauper has included all the foregoing in 1,085 pages, substantially less than the other casebooks referred to. This has been achieved, not by editing the cases beyond utility, but by the use of small type which, I hasten to add, is very attractive and easily legible. All in all, this book is an excellent addition to the field.

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[1]Kauper, The First Ten Amendments, 37 A.B.A.J. 717, 780 (1951).

I have often wondered why more practicing lawyers do not keep an up-to-date constitutional law casebook in their offices. Certainly a book such as Mr. Kauper's would afford a very helpful orientation to a general practitioner faced with a question under the U. S. Constitution. It might also serve the useful purpose of reminding busy practitioners of something which too many of them tend to forget. What I refer to is illustrated by a remark made to me last year by a Mississippi lawyer, "Why, the Supreme Court is not a law court any more. It's just a bunch of politicians." (I would not undertake to estimate how many similar, and less printable, remarks were made in the state during the days following May 17, 1954).

My friend's remark revealed that he had forgotten two important and basic facts about our Constitutional system and the Supreme Court's place in it. First, the nature of the Supreme Court's function in interpreting and applying the Constitution. The bare words of the broad generalities granting and limiting power do not by themselves, of course, in any given case mean much of anything. When a Supreme Court justice is faced with was stated about as well as I have ever seen it by Mr. Kauper in his 1951 prize-winning Ross essay for the American Bar Association:

"But constitutional interpretation is no . . . simple matter. The judge faces the task of giving meaning to words very often in the context of broad phrases that admit of a great variety of interpretations. Whether he takes into account the historical circumstances that gave birth to the words, whether he draws upon judicial tradition and precedent, whether he resorts to a process of didactic interpretation that gives a logical meaning to words apart from their setting in time and place, whether he measures the results of his interpretation by the interests at stake and his conception of the kind of politico-socio-economic order that should function within the structure of the constitutional system, he is in any event determing the meaning of words in a situation where meaning is not automatically decipherable. A host of considerations may converge upon and condition his thinking but in the end choose and decide he must."[1]

The second thing my friend forgot is a corollary of the first. That is that throughout our history the Supreme Court has always been more than just a "law court"; it has been a true policy-making branch of the government, often paramount to Congress and the President. Using "political" in the broad sense to refer to high level decisions of state, it is apparent that the Supreme Court's decisions have always been political, rather than purely and simply judicial. At the Supreme Court level, law and policy are inseparable. Similarly, Supreme Court justices in the truest performance of their duties, have not been mere judges but have been high policy decision makers —"politicians" yes, but not in the invidious sense of the word. That the Court has deferred to Congress and the President as the ultimate policy-makers in certain areas does not detract from the general validity of the observation. And disagreement, however emphatic, with a particular decision should not blind us to the historic function of the Court.

William P. Murphy

How to Prove a Prima Facie Case. By Howard Hilton Spellman. New York, Prentice-Hall, Inc., 1954. Pp. 691. $8.50.

Although to be read as a whole it will serve as an excellent refresher, *How to Prove a Prima Facie Case* is essentially a book to be used as a quick reference for determining the elements and manner of proof of a number of the more common causes of action. It is divided into three main subdivisions or parts, namely: "Part I. Introduction: How to Use This Volume;" "Part II. Prima Facie Cases;" and "Part III. Proof of Situations Common to Various Causes of Action." Part II is further sudbivided into 131 forms, each form illustrating proper questions to be propounded to a witness (with answers) in order to make out a prima facie case for each particular cause of action exemplified. Following each question and answer form are certain key "Hints" relating to the elements of that particular cause of action. Under Form No. 8, having to do with Bailments and Public Checking, for example. the first hint is as follows: "1. Payment for the bailment should be shown. A bailee for hire is liable for a mere failure to return the bailed article, whereas a gratuitous bailee is only liable in cases of gross negligence." This statement of law or "Hint", as the author chooses to call it, is then substantiated by numerous leading decisions on that point of law. Other hints, however, are sometimes substantiated by quotations from leading cases in point. Finally, at the end of each form, are citations in point from each jurisdiction.

Part III, "Proof of Situations Common to Various Causes of Action," consists of twenty-two forms, followed by hints and citations, arranged in similar fashion as those found in Part II. The forms in Part III range in subject matter from the manner of proof of telephone conversations (Form 153) to expert testimony (Forms 143, 144).

It seems to the reviewer that this book would have more value to the average lawyer if more emphasis were placed on Part III and less on Part II. Almost every law office is equipped with a standard encyclopedia from which can be easily ascertained the elements of any cause of action covered by the book under review. Although the citations at the end of each form are convenient, except as a quick reference, Part II of the book, therefore, does not particularly recommend itself to the reviewer. Part III, however, is valuable in a limited sort of way in that it furnishes the attorney who is unfamiliar with the manner of proof of a given situation with a guide which he may apply, with adaptations, to his own case. Of course, this would also hold true in so far as Part II and the proof of the case proper is concerned; but it has been the reviewer's experience that proof of particular situations causes more difficulties to the average lawyer than proof of the bare elements of a cause of action.

In summary, therefore, it is the reviewer's impression that, although the subject book has some value as a refresher, as a quick reference and as a guide, particularly to the novitiate, its inclusion in the average law library would be superfluous.

Wm. Byron Long
Attorney at Law
Tupelo, Mississippi

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